CHAPTER 1

MARGINAL TAX RATES

REDUCE MARGINAL TAX RATES

General Explanation

Chapter 1.01

Current Law

The amount of tax imposed on taxable income in excess of the zero bracket amount of individuals varies from a minimum rate of 11 percent to a maximum rate of 50 percent. There are different rate schedules for four classes of taxpayers: (1) married individuals filing jointly and certain surviving spouses (14 tax rates); (2) heads of households (14 tax rates); (3) single individuals (15 tax rates); and (4) married individuals filing separately (14 tax rates). Beginning next year (1985), the progression of the rates for each class of taxpayers will be adjusted annually for inflation as measured by the Consumer Price Index.

Reasons for Change

The accumulation of tax exclusions and deductions over the years has substantially eroded the tax base, forcing higher rates of tax on nonexcluded income. High marginal tax rates create disincentives for saving, investing, and working. These in turn constrict economic growth and productivity.

The Treasury Department proposals would expand the base of income by eliminating many current deductions and exclusions unrelated to the proper measurement of taxable income. This expanded base permits a significant reduction in marginal tax rates without impairing Federal income tax revenues.

Proposal

The current 14 tax rates (15 for single taxpayers) would be replaced by three rates -- 15, 25, and 35 percent as shown on Table 1.

Effective Date

The proposal would be effective on July 1, 1986.

Analysis

The proposal would reduce individual tax liabilities an average of 8.5 percent; marginal tax rates on economic income would be 20 percent lower than under current law. The percentage reduction in taxes is greater at the bottom of the income scale, due to the increase in the tax threshold. Tax liabilities of families with incomes below $10,000 would fall by an average of 32.5 percent and the reduction in taxes for families with incomes of $10,000 to $15,000 would be 16.6 percent.

Proposed Tax Rates for 1986

Taxable Income Covered by the Tax Rate 1/

Head of	Married Filing			
Tax Rate	Single Returns	Joint Returns	Household Returns	Separately Returns
0%	Less than $2,800	Less than $3,800	Less than $3,500	Less than $1,900
15%	$2,800 to $19,300	$3,800 to $31,800	$3,500 to $25,000	$1,900 to $15,900
25%	$19,300 to $38,100	$31,800 to $63,800	$25,000 to $48,000	$15,900 to $31,900
35%	$38,100 and over	$63,800 and over	$48,000 and over	$31,900 and over

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1/ Taxable income is equal to adjusted gross income less $2,000 for each exemption for a taxpayer or dependent.

CHAPTER 2

FAIRNESS TO FAMILIES

Fair and simple taxation of the family unit is a vital component of the Treasury Department proposals. The proposals would accomplish these goals by redefining the tax threshold and by simplifying and rationalizing the provisions affected by the composition of the family unit.

Families with income at or below the poverty level should not be subject to income tax. Thus, the level of income at which tax is first paid would be raised so that for most taxpayers it approximates the poverty level. This would be accomplished by raising the zero bracket amounts, relatively more in the case of heads of households, and doubling the personal exemption compared with its 1984 level. These proposed changes are designed to reflect differences in ability to pay taxes that result from differences in family size and composition. The working poor would also be protected by indexing the earned income credit for inflation.

Special relief for the blind, elderly, and disabled would be consolidated in a single tax credit, and the existing child care credit would be replaced with a more appropriate deduction. In light of the flatter rate schedule, which increases work incentives for taxpayers generally, the two-earner deduction would be repealed.

INCREASE ZBA AND PERSONAL EXEMPTIONS

General Explanation

Chapter 2.01

Current Law

Individual income tax rates begin at 11 percent and progress to a top marginal rate of 50 percent. For nonitemizing taxpayers, no tax is imposed on taxable income up to the "zero bracket amount" (ZBA), which is $2,300 for unmarried individuals and heads of households, $3,400 for married couples filing joint returns and certain surviving spouses, and $1,700 for married individuals filing separately. Generally, a taxpayer may elect to itemize deductions only if the total amount of deductions exceeds the applicable ZBA.

In computing taxable income, each taxpayer is entitled to a personal exemption of $1,000 and to a dependency exemption of $1,000 for each of the taxpayer's dependents. If the taxpayer is blind or 65 years of age or older, an additional personal exemption of $1,000 is provided. On a joint return, each spouse is entitled to claim the applicable number of personal exemptions.

Beginning in 1985, the ZBA and the amount deducted from income for each personal and dependency exemption will be adjusted for inflation. The percentage increase in each amount will equal the percentage increase in prices during the previous fiscal year, as measured by the consumer price index for all urban consumers. For 1985, the ZBA will be $2,390 for unmarried individuals and heads of households, $3,540 for married couples filing joint returns and certain surviving spouses, and $1,770 for married individuals filing separately. Each personal and dependency exemption will be $1,040.

Reasons for Change

The sum of personal and dependency exemptions plus the ZBA establishes a tax threshold below which a taxpayer's income is exempt from taxation. The current levels of the ZBA and the personal and dependency exemptions do not exempt from tax an amount necessary to maintain a minimum standard of living. Moreover, as family size increases, the cost of maintaining a minimum living standard increases more rapidly than the amount of income exempt from tax. For example, in 1986 a family of four generally would start paying tax when its income exceeds $9,613, which is approximately $2,000 below the poverty threshold for such families.

The additional personal exemptions provided to the blind and the elderly serve to exempt the cost of a minimum standard of living for two select classes of taxpayers. For all classes of taxpayers, however, there is a need to adjust the existing levels of the ZBA and personal and dependency exemptions.

Because the current tax thresholds have not kept up with increases in incomes, the number of persons required to file returns has grown, along with the percentage of taxpayers forced to itemize deductions. The increase in returns and itemizers places additional recordkeeping burdens on taxpayers and also drains the resources of the Internal Revenue Service. These increased costs are frequently out of proportion to the amounts of tax involved.

Proposal

The ZBA would be increased to $2,800 for single returns, $3,800 for joint and certain surviving spouse returns, $1,900 for returns for married persons filing separately, and $3,500 for head of household returns. The amount deductible for each personal and dependency exemption would be increased to $2,000. The additional exemptions for the blind and the elderly would be repealed, but special tax treatment for the elderly, blind, and disabled would be combined into a single tax credit. See Ch. 2.02.

Effective Date

The proposal would apply for taxable years beginning on or after January 1, 1986.

Analysis

Table 1 compares the proposed changes in the personal exemptions and ZBA to current law for 1986. The personal exemption for taxpayers, spouses, and dependents for 1986 would be increased to $2,000, compared to $1,090 (after indexing for inflation expected to occur in 1985). The zero bracket amounts for single returns, head of household returns, and joint returns also would increase, as shown on Table 1.

Although the additional exemptions for the blind and the elderly would be repealed, low-income elderly and blind persons would be eligible for the expanded credit for the elderly, blind, and disabled. When the proposed increase in the personal exemptions is combined with the expanded credit, the tax-free income level for elderly and blind persons would increase. The expanded tax credit would ensure that the income of low-income elderly and blind individuals would be exempt from tax.

Table 1

Comparison of Personal Exemption and ZBA
Under Current Law and Treasury Department Proposal

	1986 Levels	
	Current Law 1/	Treasury Proposal
Personal Exemption		
For taxpayers, spouses, and and dependents (each)	$1,090	$2,000
For the blind and the elderly (each)	1,090	2/
Zero-Bracket Amount		
Single persons	2,510	2,800
Heads of households	2,510	3,500
Married couples	3,710	3,800

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1/ Includes indexation for expected inflation in 1985.

2/ Replaced with expanded credit.

Table 2 compares tax-free income levels for 1986 under current law and the proposal with poverty thresholds for households of different sizes and compositions. Under the Treasury Department proposal, the tax-free income levels would be increased for single persons and families of all sizes. For example, the tax-free income level for a one-earner married couple with no dependents would increase from $5,890 to $7,800. A one-earner married couple with two children would pay no income tax unless its income exceeded $11,800. Under current law, the same family would pay tax on income above $9,613, assuming full use of the earned income credit.

Table 2 also shows that the proposed increases in the ZBA and personal exemption would exempt families in poverty from income tax. Although the gap between the tax-free income level and poverty threshold would be narrowed for single persons without dependents, the tax-free income level for such taxpayers would still be $1,000 less than the poverty level. If the tax-free income level for single persons were raised further to close the gap, however, single persons who decided to marry would experience a tax increase or "marriage penalty." Moreover, since single persons frequently live with relatives or unrelated persons, comparison of the tax-free income levels with the poverty threshold is often misleading for many of these individuals. When the tax-free income level for single persons is combined with the tax-free income levels of parents or other household members, the combined tax-free income level may exceed the poverty level.

Table 2

Comparison of the Poverty Threshold and the Tax-Free Income Level Under Current Law and the Treasury Proposal (1986 Levels)

Status	Poverty Threshold	Tax-free Income Levels: Current Law 1/	Tax-free Income Levels: Treasury Proposal
Single persons without dependents	$ 5,800	$3,600	$ 4,800
Heads of households with one dependent 2/	7,900	7,979	9,303
Married couples 3/	7,400	5,890	7,800
Married couples with two dependents 2/ 3/	11,600	9,613	11,800

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1/ Includes expected indexation for inflation in 1985.

2/ Assumes full use of the earned income tax credit where applicable.

3/ Assumes one earner.

COMBINE TAX BENEFITS FOR ELDERLY, BLIND AND DISABLED INTO EXPANDED CREDIT

General Explanation

Chapter 2.02

Current Law

Individuals aged 65 or over and certain disabled persons are eligible for a nonrefundable credit equal to 15 percent of a defined "base amount." The base amount for the credit is computed by reference to the individual's "initial base amount." For those aged 65 or over, the initial base amount is $5,000 for a single person (or for a married couple filing jointly if only one spouse is aged 65 or over). If both spouses are 65 or older, the initial base amount is $7,500 if they file a joint return and $3,750 if they file a separate return and live apart at all times during the year.

The actual base amount for the credit is equal to an individual's initial base amount reduced by (i) the amount of nontaxable pension and annuity income (principally social security benefits) and most nontaxable disability payments, or (ii) one-half of the taxpayer's adjusted gross income in excess of $7,500 (for single taxpayers), $10,000 (for married couples filing joint returns), or $5,000 (for married individuals filing separate returns). When applied to the elderly, the credit provides a compensating tax benefit to those individuals who receive little or no social security benefits and hence derive little or no advantage from the exemption of such benefits from tax.

Individuals under age 65 also may qualify for the credit if (i) they receive employer-provided disability income or other taxable disability income and (ii) they are (or are expected to be) totally disabled for at least one full year. For these individuals, the initial base amount is the lesser of such disability income or the initial base amount that would apply if they were elderly. In these cases, the credit provides individuals receiving taxable disability payments with treatment comparable to that provided for recipients of tax-free workmen's compensation and veterans' disability payments.

Elderly, blind, and disabled taxpayers also receive preferential treatment in other sections of the Code. A taxpayer is allowed an additional personal exemption upon attaining age 65, and an additional exemption if he or she is blind. Each exemption reduces taxable income by $1,090 for 1986. In addition, most disability income is untaxed, including workers' compensation, black lung payments, veterans' disability payments, and personal injury awards. Finally, social security benefits (including social security disability income) are excluded from income unless the taxpayer's adjusted gross income (with certain modifications) exceeds $25,000 ($32,000 in the case of a joint return); in no event are more than one-half of such benefits included in income.

Reasons for Change

The preferential treatment applicable to elderly, blind, and disabled taxpayers recognizes the special hardships and costs such individuals encounter.

Certain of the tax benefits available to such taxpayers under current law, however, provide the greatest benefit to those least in need. Thus, the additional personal exemptions for the elderly and blind provide the greatest benefit to those of the elderly and blind with the highest incomes. A $1,090 exemption is worth $545 to an individual in the 50 percent tax bracket, but only $218 to an individual in the 20 percent tax bracket. There is no justification for this disparity.

In contrast, the current credit for the elderly targets its assistance to those with the greatest need. Because of the dollar-for-dollar offset for social security benefits, the credit provides no benefit to those who receive the average level of social security benefits. Moreover, because the credit is phased out as income increases, it provides the greatest benefit to low-income taxpayers. The credit for taxable disability payments operates in the same manner, and thus similarly targets its benefits to low-income taxpayers.

Finally, current law requires that an individual expect to be fully disabled for a period of one year in order to receive the credit. Limiting eligibility to the long-term disabled is of questionable fairness and introduces significant interpretive and enforcement problems.

Proposal

The current special tax benefits for the elderly, blind, and disabled would be combined in a single credit, similar to the current credit for the elderly and disabled. All taxable disability income would be made eligible for the credit, regardless of the length of disability.

The amount of the credit would be calculated in the same manner as under current law. The initial base amount for the blind and those over 65 would be $6,000 (in the case of single taxpayers or taxpayers filing joint returns that include only one blind or elderly taxpayer), $9,000 (in the case of joint returns where both spouses are blind or over 65), $7,500 (in the case of heads of households who are either blind or over 65), or $4,500 (in the case of a married individual filing a separate return who is either blind or over 65 and has lived apart from his or her spouse for the entire year).

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986. Only taxable disability income would be eligible for the credit. The Treasury Department proposals would require taxation of most workers' compensation, black lung, and veterans' disability payments received after January 1, 1987. Thus, with respect to such payments, the proposal generally would be effective on or after January 1, 1987.

Analysis

Table 1 summarizes the proposed increase in the maximum amount eligible for the 15 percent credit. When combired with the proposed increase in the personal and dependent exemptions (to $2,000), the expansion of the credit for the elderly, blind, and disabled would increase the tax-exempt threshold for elderly taxpayers, despite the elimination of their additional exemptions. The tax-exempt level of income would increase from $14,508 to $14,533 for an elderly couple with no social security income and from $9,414 to $9,700 for a single elderly individual with no social security income. For those receiving average amounts of social security, the tax-exempt threshold would rise from $16,740 to $16,800 for a couple and from $10,404 to $10,800 for single individuals. These tax-exempt levels are far in excess of those for taxpayers generally ($7,800 for couples; $4,800 if single).

Similarly, the tax-exempt level of income for the non-elderly blind receiving no tax-free income would increase substantially -- from $4,580 to $9,700 for blind single taxpayers, and from $7,800 to $14,533 for a couple if both are blind.

The proposal would provide more consistent and more equitable treatment for these groups and for the disabled. It also would eliminate artificial distinctions between sources of disability income. The effect of extending the credit to all forms of disability income is discussed more fully in Chapter 3.14, relating to proposed changes in the taxation of workers' compensation, black lung benefits, and veterans' disability payments.

Table 1

Maximum Amount Eligible for 15 Percent Credit

	Current Law	Proposal
Age 65 or over		
Single	$5,000	$6,000
Joint Return	7,500	9,000
Blind (and under age 65)		
Single	0	6,000
Joint Return	0	9,000
Under age 65 with taxable disability income		
Single	5,000	6,000
Joint Return	7,500	9,000

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REPEAL TWO-EARNER DEDUCTION

General Explanation

Chapter 2.03

Current Law

The progressive tax rate structure often results in higher marginal tax rates for couples whose incomes are combined as a result of marriage. This contributes to the so-called "marriage penalty" of current law, i.e., the increase in a couple's aggregate tax liability that may occur as a consequence of marriage. The marriage penalty is ameliorated in part by the joint return rate schedule, under which married couples are taxed at lower rates than a single person with the same amount of taxable income. Because of the joint return rate schedule, marriage can result in a reduction of tax liability for some couples. Whether marriage actually results in a tax penalty or "bonus" depends principally on the total amount of a couple's taxable income and the percentage of such income allocable to each spouse.

In response to the marriage penalty, current law provides a special deduction for married couples in which both spouses earn personal service income. Thus, two-earner married couples who file joint returns may deduct from gross income the lesser of $3,000 or ten percent of the qualified earned income of the spouse with the lower qualified earned income for the taxable year.

Reasons for Change

The current deduction for two-earner married couples is poorly designed to offset the increased tax liabilities that some couples face as a result of marriage. The deduction does not eliminate the marriage penalty for many couples, and for some it provides a benefit that exceeds any increase in tax liability caused by marriage. For still others, the deduction merely increases the marriage bonus. Moreover, because the deduction applies only to earned income, it has no effect when the marriage penalty arises from investment income.

The marriage penalty under current law is attributable primarily to the progressive rate structure and to the joint return concept, under which a married couple's income is aggregated for tax purposes. Abandonment of the joint return system would eliminate the marriage penalty, but would reintroduce a host of questions concerning how a couple's income and deductions may be allocated between spouses. Moreover, taxing a married couple on the same basis as two single persons with equivalent combined income ignores that married couples frequently pool their incomes and may benefit from shared living expenses. An equally direct but better conceived response to the marriage penalty is to reduce marginal tax rates, which at current high levels may discourage labor force participation or reduce the number of hours worked by second earners (typically married women).

Proposal

The deduction for two-earner married couples would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The Treasury Department proposals include flatter tax rate schedules and lower marginal tax rates. In general, these changes would reduce the significance of tax consequences in individual decisions and improve incentives for taxpayers to work and invest. Since the tax structure would retain a degree of progressivity, as well as joint return treatment for married couples, the Treasury Department proposals would not eliminate the possibility of a marriage penalty, nor, for that matter, of a marriage bonus. They represent, however, a more direct and consistent attempt to minimize the impact of marriage on tax liabilities than the current two-earner deduction.

Repeal of the two-earner deduction would eliminate Schedule W and one line from Form 1040 and seven lines from Form 1040A. It may also increase the number of taxpayers eligible to file Form 1040EZ.

INDEX EARNED INCOME TAX CREDIT

General Explanation

Chapter 2.04

Current Law

An eligible individual is allowed a refundable credit against income tax equal to ten percent of the first $5,000 of earned income. The maximum credit of $500 is reduced by an amount equal to 12.5 percent of the excess of adjusted gross income (AGI) or earned income (whichever is greater) over $6,000. Thus, the credit is eliminated when AGI or earned income reaches $10,000. Earned income eligible for the credit includes wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment.

An individual is eligible for the earned income credit only if the individual lives in the United States and (1) is married, files a joint return, and is entitled to a dependency exemption for a child living with the taxpayer, (2) is a surviving spouse, or (3) is the head of a household and entitled to a dependency exemption for a child living with the individual for more than one-half of the taxable year.

Beginning in 1985, the earned income credit will be increased to 11 percent of the first $5,000 of earned income. The maximum credit of $550 will be reduced by 12 2/9 percent of the excess of AGI or earned income over $6,500. Thus, the credit will be eliminated when AGI or earned income reaches $11,000.

The maximum credit amount and the AGI or earned income limits are not indexed for inflation.

Reasons for Change

The earned income credit serves as an offset to social security and income taxes and provides work incentives for many low-income families with dependents. However, increases in income attributable to inflation have reduced the number of families eligible for the credit and the amount of the credit for those who remain eligible for it.

The Tax Reform Act of 1984 countered this trend by increasing the credit percentage, maximum credit, and income limit for the credit. The new amounts, however, are not indexed and will remain fixed until changed by legislation.

To eliminate the need for periodic legislative adjustments in the credit, the maximum earned income credit amount and the AGI or earned income limit should be indexed to the rate of inflation.

Proposal

The maximum earned income credit and the AGI or earned income limit would be adjusted for inflation. The amount of the adjustment in a given calendar year would depend on the percentage increase in consumer prices for the previous fiscal year, as measured by the consumer price index for all urban consumers (CPI).

Effective Date

The proposal would apply for taxable years beginning on or after January 1, 1986. Adjustments in inflation for 1986 would be based on changes in the CPI for the 1985 fiscal year.

Analysis

In 1982, approximately 6.4 million returns (6.7 percent of total returns) claimed earned income tax credits totalling $1.6 billion. Indexation of the earned income credit would ensure that inflation-induced increases in incomes would not reduce the credit for some low-income families and exclude other low-income families from eligibility. For example, assume that an eligible taxpayer earning $6,500 in 1984 receives a five percent increase in income in 1985 and that inflation also increases by five percent during the same period. Although the taxpayer's nominal income has increased, his or her "real" income (i.e., income adjusted for inflation) has stayed the same. Under current law, however, the taxpayer's earned income credit would fall from $550 to $510, because nominal income has increased. Under the proposal, the earned income limit and maximim credit would be increased by five percent for 1986. Thus, the taxpayer would be eligible for a credit of $578, the inflation-adjusted value of the maximum credit.

REPLACE CHILD AND DEPENDENT CARE CREDIT WITH DEDUCTION

General Explanation

Chapter 2.05

Current Law

A nonrefundable credit is allowed to an individual who pays employment-related child and dependent care expenses provided the individual maintains a household for one or more "qualifying individuals." In general, a qualifying individual is (1) a dependent of the taxpayer who is under the age of 15 and for whom the taxpayer can claim a dependency exemption, (2) a dependent of the taxpayer who is physically or mentally incapable of taking care of himself or herself, or (3) a spouse of the taxpayer if the spouse is physically or mentally incapable of taking care of himself or herself.

Dependent care expenses are considered to be employment-related only if they are incurred to enable the taxpayer to work and are paid for household services and the care of one or more qualifying individuals. Expenses for household services include the performance of ordinary and usual maintenance in the household, provided the expenses are attributable in part to the care of a qualifying individual. Thus, amounts paid for the services of a maid or cook qualify for the credit if part of the services performed are provided for a qualifying individual.

The amount of employment-related expenses that are eligible for the credit is subject to both a dollar limit and an earned income limit. Employment-related expenses are limited to $2,400 for one qualifying individual and $4,800 for two or more qualifying individuals. Further, employment-related expenses generally cannot exceed the earned income of the taxpayer, if single, or, for married couples, the earned income of the spouse with the lower earnings. Married couples must file a joint return to claim the credit.

Taxpayers with adjusted gross incomes of $10,000 or less are allowed a credit equal to 30 percent of eligible employment-related expenses. For taxpayers with adjusted gross incomes of $10,000 to $28,000, the credit is reduced by one percentage point for each $2,000 or fraction thereof above $10,000. The credit is limited to 20 percent of employment-related child and dependent care expenses for taxpayers with adjusted gross incomes above $28,000.

Reasons for Change

Child and dependent care expenses incurred in order to obtain or maintain employment affect a taxpayer's ability to pay tax in much the same manner as other ordinary business expenses. A family with

$30,000 of income and $2,000 of employment-related child care expenses does not have greater ability to pay tax than one with $28,000 of income and no such expenses.

There is, of course, a personal element in dependent care expenses incurred for household services and the care of one or more qualifying individuals. No objective standards exist, however, for allocating child and dependent care expenses based upon the personal and business benefits derived. Moreover, the cost of dependent care is frequently substantially higher than other mixed business/personal expenses for which no deduction is allowed, such as the costs of commuting and most business clothing. Disallowance of all dependent care costs in the computation of taxable income thus could generate a significant work disincentive.

Allowance of a deduction is the appropriate treatment of costs incurred in producing income. The current credit for dependent care expenses is targeted for the benefit of low-income taxpayers, although these expenses reduce the ability to pay tax at all income levels. Tax relief for low-income taxpayers is provided best through adjustments in tax rates or in the threshold level of income for imposition of tax. Such changes benefit all similarly situated taxpayers.

Computation of the limits on the dependent care credit also adds to the complexity of the tax law.

Proposal

A deduction from gross income would be provided for qualifying child and dependent care expenses up to a maximum of $2,400 per year for taxpayers with one dependent, and $4,800 per year for taxpayers with two or more dependents. Qualifying expenses would continue to be limited by the taxpayer's earned income, if single, or, in the case of married couples, by the earned income of the spouse with the lower earnings.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986.

Analysis

The proposal recognizes that child and dependent care expenses constitute legitimate costs of earning income. The extent to which such expenses also provide a personal benefit, however, varies in each situation. As with certain other expenditures that provide mixed business and personal benefits to taxpayers, such as business meal and entertainment expenses, the proposal sets an objective limitation on the amount allowed as a deduction. This limit to some extent serves to deny a deduction for the portion of dependent care expenses constituting personal rather than business benefit. An objective limit also simplifies the tax law.

Under the proposal, approximately five million families (65.5 percent of all families) would claim deductions for dependent care expenses totalling approximately $7 billion. Approximately 61 percent of these deductions would be claimed by families with incomes under $50,000. The deduction, however, is relatively less favorable to low-income families than is the current credit. The choice of the deduction reflects the view that progressivity should be provided directly through the rate structure.

CHAPTER 3

FAIR AND NEUTRAL TAXATION

Part A. Excluded Sources of Income--Fringe Benefits

Current Law

An employee is generally required to include in gross income all compensation received during the year from his or her employer, regardless of whether the compensation is paid in cash or in property or other in-kind benefits. Current law, however, exempts from taxation certain employer-provided in-kind benefits, such as the cost of group-term life insurance (up to $50,000), educational assistance, accident and health insurance, group legal services, and dependent care assistance. These and certain other fringe benefits are expressly excluded from an employee's taxable income if provided under qualified employer-sponsored plans.

Reasons for Change

Compensation paid in the form of in-kind benefits is not different in principle from compensation paid directly in cash. The employee who receives fringe benefits is not in a different pre-tax economic position than the employee who receives cash compensation and uses it to purchase the same benefits. The exclusion of certain fringe benefits from income under current law is thus unrelated to the proper measurement of income. It is intended instead to reduce the after-tax cost of certain goods or services and thereby to subsidize consumption of such items by eligible taxpayers.

Assume, for example, that an employee in a 40 percent marginal tax bracket is given the choice of receiving $500 in cash compensation or $500 in personal legal services that qualify as a nontaxable fringe benefit. If the employee were required to purchase the same services directly, their $500 cost might well outweigh their value to the employee. Since the after-tax value of the $500 cash compensation is $300, however, the effective cost to the employee of the legal services, as a nontaxable benefit, is also $300. As a consequence, the employee may well decide to take the legal services, even though their value to the employee may be less than their market cost and the employee would not purchase them directly.

A government subsidy for a good or service may be appropriate where consumer demand for the item does not reflect its social value or the social cost of failing to provide it. Thus, existing policies to ensure retirement security and essential health care may justify certain tax or direct incentives to encourage employers and employees to provide for these items. Increasingly, however, tax-favored fringe benefit treatment has been extended to nonessential employer-provided benefits for which no external incentive is necessary or appropriate.

The use of the tax system to subsidize employee consumption of these nonessential benefits is unfair to taxpayers generally, reduces economic efficiency and forces higher than necessary marginal tax rates.

The tax-free character of fringe benefits causes employees to overconsume these benefits relative to their actual desire or, in many cases, need for them. Such overconsumption distorts the allocation of resources and raises prices for the services available in nontaxable form. The spiraling costs of health care in recent years may be attributable in significant part to overconsumption of health care by employees for whom such care is not only tax free but, in many cases, available without limit. The costs of such price distortions are distributed throughout the economy and affect all taxpayers. They fall most cruelly upon those who do not receive employer-provided health care and other fringe benefits but must pay for such services out of their own pockets.

The exclusion of fringe benefits from income is also inconsistent with the tax system's principles of horizontal and vertical equity. Taxpayers not working for employers with qualified benefit plans must purchase goods or services such as term life insurance or legal services with after-tax dollars. In contrast, taxpayers receiving the same goods as fringe benefits in effect purchase them with pre-tax dollars. As a result, two taxpayers with identical economic incomes may pay significantly different amounts in taxes depending on the proportion of income that each receives in the form of fringe benefits.

The unequal distribution of fringe benefits has caused some to conclude that they should be made even more broadly available. This approach would only exacerbate the distortions and revenue costs of existing law, and it would remain seriously unfair to lower income taxpayers. Under the progressive rate structure, an exclusion from income yields a greater tax benefit to a high-bracket taxpayer than to a low-bracket taxpayer. Thus, even if all taxpayers received the same amounts of non-taxable fringe benefits, the exclusion of such benefits from income would still provide a disproportionate benefit to higher income taxpayers.

A final and most serious consequence of the current exclusion of fringe benefits from income is the resulting erosion of the tax base. As the base of taxable income narrows, the rates of tax on nonexcluded income must increase in order to maintain the same level of revenue. The percentage of total compensation paid as fringe benefits has grown significantly in recent years, as employees and employers have understandably responded to the tax system's incentives. This shrinkage of the tax base must be reversed before meaningful reductions in tax rates can be achieved.

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Proposal

The exclusion of most statutory fringe benefits from income would be repealed. The current exclusion of employer-provided health care would be retained subject to limits on the maximum amount of such insurance that could be provided tax free. These proposals are described in greater detail in the following sections. See also Ch. 17 regarding the tax treatment of individual and employer retirement savings plans.

LIMIT EMPLOYER-PROVIDED HEALTH INSURANCE

General Explanation

Chapter 3.01

Current Law

All employer contributions to health insurance plans on behalf of an employee are excluded from the employee's gross income, regardless of the cost or extent of the coverage. The same rule generally applies to amounts paid by an employer to or on behalf of an employee under a self-insured medical plan.

Although medical expense reimbursements under a self-insured plan must be provided on a nondiscriminatory basis to be excludable, similar benefits provided through an outside insurer are not subject to nondiscrimination rules.

Reasons for Change

As with other tax-free fringe benefits, the exclusion of employer-provided health insurance from income subsidizes the cost of such insurance for eligible taxpayers. Within limits, this tax-based incentive for employee health insurance is an appropriate part of the national policy to encourage essential health care services. In its present unlimited form, however, the exclusion provides disproportionate benefits to certain taxpayers, encourages the overconsumption of health care services, and contributes to higher than necessary marginal tax rates.

The exclusion from income of employer-provided health insurance is unfair to individuals who are not covered by employer plans and who must therefore pay for their health care with after-tax dollars. Table 1 illustrates the impact of the exclusion on two employees each of whose compensation costs his respective employer $35,000. Individual A receives $2,400 of his compensation in the form of employer-provided health insurance; Individual B receives all of his compensation in cash. As a result, both employees receive the same level of compensation, but A's after-tax income is $809 higher than B's, simply because some of his compensation is in the form of health insurance. B must pay for any medical expenses or privately purchased insurance out of his lower after-tax earnings.

Because many employer-provided plans are so generous that the employees pay very little, if anything, out-of-pocket for health services, the employees are more likely to overuse doctor and hospital services and medical tests. The tax system subsidizes this overuse by reducing the effective cost of employer-provided insurance. As Table 1 demonstrates, A receives $2,400 in health insurance at a cost of only $1,591, since his taxes fall by $809. The rapid increase in the cost of health care services in recent years can be attributed at least in part to overconsumption of such services by employees for whom they are tax free and, in many cases, available without limit.

The unlimited exclusion for employer-provided health care has also contributed to the erosion of the tax base and to consequent high marginal tax rates. Compensation paid in this nontaxable form has grown significantly in recent years. Imposing reasonable limits on the amount of health care available tax-free is an important part of the effort to broaden the base of taxable income and reduce marginal tax rates.

In addition, the tax benefits provided for employee health care should not be available on a basis that permits discrimination between high- and low-paid employees. Thus, nondiscrimination rules should apply to employer-provided health benefits regardless of whether such benefits are self-insured or provided through third-party coverage.

Table 1

Tax Benefits Arising from the Exclusion of Employer-Provided Health Insurance 1/

	Individual A	Individual B
Total Employer Cost	$35,000	$35,000
Non-Taxable Employer-Provided Health Insurance	$ 2,400	$ ---
Employer Social Security Tax	$ 2,147	$ 2,305
Cash Wages	$30,453	$32,695
Employee Income Tax	$ 2,996	$ 3,489
Employee Social Security Tax	$ 2,147	$ 2,305
After-Tax Income Plus Value of Health Insurance	$27,710	$26,901
Cost of $2,400 of Health Insurance	$ 1,591	$ 2,400
Average Cost Per $1 of Health Insurance	$ 0.66	$ 1.00

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1/ 1985 tax rates for a family of four with no other income and with itemized deductions equal to 23 percent of adjusted gross income.

Proposal

Employer contributions to a health plan would be included in the employee's gross income to the extent they exceed $70 per month ($840 per year) for individual coverage of an employee, or $175 per month ($2,100 per year) for family coverage (i.e., coverage that includes the spouse or a dependent of the employee). These monthly dollar limits would be adjusted annually to reflect changes in the Consumer Price Index.

With respect to any employee, an employer's contribution to a health plan would be the annual cost of coverage of the employee under the plan reduced by the amount of the employee's contributions for such coverage. The annual cost of coverage with respect to an employee would be calculated by determining the aggregate annual cost of providing coverage for all employees with the same type of coverage (individual or family) as that of the employee, and dividing such amount by the number of such employees.

The annual cost of providing coverage under an insured plan (or any insured part of a plan) would be based on the net premium charged by the insurer for such coverage. The annual cost of providing coverage under a noninsured plan (or any noninsured part of a plan) would be based on the costs incurred with respect to the plan, including administrative costs. In lieu of using actual administrative costs, an employer could treat seven percent of the plan's incurred liability for benefit payments as the administrative costs of the plan. A plan would be a noninsured plan to the extent the risk under the plan is not shifted from the employer to an unrelated third party.

The cost of coverage would be determined separately for each separate plan of the employer. Coverage of a group of employees would be considered a separate plan if such coverage differs from the coverage of another group of employees.

The proposal would require that the cost of coverage under the plan be determined in advance of the payroll period. The cost would be redetermined at least once every 12 months, and whenever there are significant changes in the plan's coverage or in the composition of the group of covered employees.

If the actual cost of coverage cannot be determined in advance, reasonable estimates of the cost of coverage would be used. If an estimated cost were determined not to be reasonable, the employer would be liable for the income taxes (at the maximum rate applicable to individuals) and the employment taxes (both the employer's and the employee's share) that would have been paid if the actual cost of coverage had been used. Where an employer makes contributions to a multiemployer plan, the multiemployer plan would be treated as the employer for purposes of determining the cost of coverage and the liability for errors in estimates.

If the cost of coverage fluctuates each year depending on the experience of the employer under the plan, an average annual cost of coverage would be used, based on the average cost for the past three years (adjusted to reflect increases in health insurance costs).

Appropriate nondiscrimination rules would be applied to employer-provided health benefits, regardless of whether employer health plans are self-insured or provided through third parties.

Effective Date

The proposal would generally apply to employer contributions made with respect to payroll periods beginning on or after January 1, 1987. However, an exception would be made for contributions made under a binding contract entered into before the proposal is introduced as legislation, until the earlier of January 1, 1989 or the date such contract expires or is renegotiated.

The proposed dollar limits would apply in 1987, with indexing (based on the Consumer Price Index) starting in 1988.

Analysis

For 1987, the proposed cap on tax-free employee health care would increase the taxable income of only 30 percent of all civilian workers (or approximately one-half of civilian employees who receive some employer-provided insurance). Even for affected taxpayers, only the excess over the $175 family/$70 individual monthly ceilings would be included in gross income.

Most low-income employees would be unaffected by the proposed change because they generally receive employer-provided insurance (if at all) in amounts below the cap. Only about ten percent of those with incomes below the average for all taxpayers would have increased taxable income as a result of the proposal. In contrast, approximately 40 percent of the wealthiest one-fifth of all taxpayers would have additional taxable income as a result of the proposal, with 60 percent of the additional tax liability borne by that group. A small number of low-income workers now receive an extremely large proportion of their compensation in the form of health insurance; the impact on those workers, however, would be mitigated by the proposed increases in the personal exemptions and zero bracket amounts.

Table 2 shows how the proposal would affect a taxpayer whose compensation costs his employer $35,000, including $2,400 of employer contributions for health insurance (Taxpayer A in Table 1), assuming no other changes in current law. This employee would only pay tax on the $25 per month by which the employer's contributions exceed the ceiling. Thus, even with the proposed cap, this employee would still pay far less tax than an employee whose compensation costs his employer the same $35,000 but who received all his compensation in the form of cash. However, the subsidy would be reduced from $809 to

$707. Each dollar of the employer-provided insurance would now cost the employee an average of $0.71, just slightly more than the $0.66 under current law.

More importantly, however, each additional dollar of insurance above the $2,100 ceiling would cost a full dollar. At the margin, the employee with employer contributions above the ceiling would pay the full cost of the insurance and would therefore be more cost-conscious. As a result, the proposal would help contain escalating medical costs by spurring interest in health maintenance organizations, private cost review programs, copayments and other market-oriented cost containment approaches. Moreover, these strong incentives for cost control would be obtained without undermining the incentives for employer-provided insurance that guarantees essential health care and protects against the risk of serious injury or illness.

Table 2 illustrates the impact of implementing the health cap with no other changes in current law. Other provisions of the Treasury Department proposals would lower individual tax rates and thereby reduce the effective subsidy for employer-provided health insurance. Under these other proposals, the taxpayer discussed above would be in the 15 percent income tax bracket, and the average cost of $2,400 of employer-provided health insurance would rise to $0.71 per dollar without the health cap and $0.74 with the cap.

Table 2

Impact of a Cap on Excludable Employer Contributions for Health Insurance 1/

	Taxpayer with $2,400 of Employer-Provided Health Insurance	
	Current Law	Proposed Law
Total Employer Cost	$35,000	$35,000
Non-Taxable Employer-Provided Health Insurance	$ 2,400	$ 2,100
Employer Social Security Tax	$ 2,147	$ 2,167
Cash Wages Plus Taxable Health Insurance	$30,453	$30,733
Employee Income Tax	$ 2,996	$ 3,058
Employee Social Security Tax	$ 2,147	$ 2,167
After-Tax Income Plus Value of Health Insurance	$27,710	$27,610
Cost of $2,400 of Health Insurance	$ 1,591	$ 1,692
Average Cost per $1 of Health Insurance	$ 0.66	$ 0.71
Cost of each $1 of Health Insurance above $2,100	$ 0.64	$ 1.00

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1/ Assumes no other change in current law.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED GROUP TERM LIFE INSURANCE

General Explanation

Chapter 3.02

Current Law

The cost of employer-provided group-term life insurance is excluded from an employee's income to the extent it is not in excess of the sum of (1) the cost of $50,000 of such insurance, and (2) the amount paid by the employee for such insurance. For purposes of the exclusion, the cost of group-term life insurance is determined on the basis of uniform premiums established in Treasury regulations. The cost of certain kinds of group-term life insurance is excluded without limit, including, for example, insurance on a former employee who is disabled and insurance under which the employer is directly or indirectly the beneficiary. The exclusion is not available to self-employed individuals.

Reasons for Change

The exclusion of group-term life insurance from income causes significant inequities among taxpayers. Taxpayers receiving group-term life insurance through an employer-sponsored plan effectively purchase such insurance with pre-tax dollars, whereas taxpayers not covered by an employer plan must use after-tax dollars to acquire the same insurance. Thus, two taxpayers with identical real incomes may pay different amounts in income taxes. Moreover, even among taxpayers covered by employer plans, the exclusion of group-term life insurance favors high-bracket over low-bracket taxpayers. For a taxpayer in a 50 percent marginal tax bracket, the exclusion provides a 50 percent savings in the cost of insurance; on the other hand, for a 20 percent bracket taxpayer, the exclusion produces only a 20 percent savings.

The group-term life insurance exclusion lowers the after-tax cost of term life insurance and thus encourages employees to request and employers to provide more insurance than the employees would be willing to pay for on their own. Because this subsidy for term life insurance is provided through the tax system, its actual cost to society is difficult to control or monitor. As with other fringe benefit exclusions, the group-term life insurance exclusion also narrows the tax base and thus causes higher than necessary marginal tax rates.

Proposal

The exclusion of group-term life insurance from income would be repealed. Group-term life insurance provided by an employer would be taxable under the same general principles that apply to other employer-provided fringe benefits.

Effective Date

The repeal generally would be effective for group-term life insurance provided on or after January 1, 1987. However, the exclusion would continue for such insurance if provided under a binding contract entered into prior to the date this proposal is introduced as legislation, until the earlier of January 1, 1989 or the date such contract expires or is renegotiated.

Analysis

Almost one-half of all families receive some employer-provided group-term life insurance. Such insurance accounts for approximately 40 percent of the value of all life insurance in force. Given the lower rates available through group-term insurance, most employers are expected to continue to make such insurance available.

REPEAL $5,000 EXCLUSION FOR EMPLOYER-PROVIDED DEATH BENEFITS

General Explanation

Chapter 3.03

Current Law

Death benefits paid by an employer to the estate or beneficiaries of a deceased employee are excluded from the recipient's income. The maximum amount that may be excluded from income with respect to any employee is $5,000. Accordingly, an allocation of this exclusion is required if multiple beneficiaries receive, in the aggregate, more than $5,000. Except with respect to certain distributions from or under qualified plans, the exclusion does not apply to self-employed individuals.

In addition to the statutory exclusion, some courts have permitted taxpayers to exclude from income payments from a decedent's employer in excess of $5,000. The rationale of these cases is that the employer's payment to the decedent's estate or beneficiary constitutes a gift rather than compensation. Such "gifts" are not subject to the $5,000 limitation.

Reasons for Change

The exclusion of certain death benefits from income creates an artificial preference for compensation to be paid in this form. The exclusion of such benefits from the tax base causes the tax rates on other compensation to increase. Moreover, the exclusion is unfair because it is not available to all taxpayers (such as self-employed individuals).

Finally, confusion exists under present law as to whether a payment by an employer to a deceased employee's family constitutes a death benefit subject to the $5,000 limitation or a fully excludable gift. Treatment of such a payment as a gift is contrary to economic reality and leads to different tax treatment on similar facts.

Proposal

The proposal would repeal the $5,000 exclusion for employer-furnished death benefits. Any amount paid by or on behalf of an employer by reason of the death of an employee to the estate or a family member or other beneficiary of the decedent would be characterized as a taxable death benefit rather than as an excludable gift.

Effective Date

The repeal would be effective for benefits paid due to deaths occurring on or after January 1, 1986. The exclusion would continue, however, for amounts paid under a binding, written employment contract entered into prior to the date this proposal is introduced as legislation, until the earlier of January 1, 1989 or the date such contract expires or is renegotiated.

Analysis

Approximately $400 million of employer-provided death benefits are excluded from income under current law. As with all exclusions, the tax benefit per dollar of the death benefit exclusion increases with the recipient's tax bracket. Thus, the exclusion provides the greatest assistance to high-income taxpayers, who are also more likely to receive such benefits than low-income taxpayers.

Moreover, the Treasury Department proposals would repeal the current exclusion from income of employer-provided group-term life insurance. Absent repeal of the death benefit exclusion, the taxation of employer-provided group-term life insurance would encourage employers to recharacterize life insurance as an excludable death benefit.

Finally, a specific provision that payments from an employer to a deceased employee's estate or family do not constitute gifts would simplify current law and also reduce the unfairness created by current law where similar facts may lead to different tax results.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED LEGAL SERVICES

General Explanation

Chapter 3.04

Current Law

Gross income of an employee does not include personal legal services provided by an employer under a qualified group legal services plan nor does it include amounts contributed by an employer on behalf of an employee under such a plan. A qualified group legal services plan must satisfy certain statutory rules, including provisions regarding nondiscrimination in eligibility, contributions, and benefits.

The group legal services exclusion is currently scheduled to expire for taxable years ending after December 31, 1985.

Reasons for Change

The exclusion from income of employer-provided group legal services encourages overconsumption of legal services by permiting employees to purchase them with pre-tax dollars. The exclusion is also unfair because it is not available to all taxpayers and, where available, is of greater benefit to high-income taxpayers. Finally, by encouraging employees to take more of their compensation in this untaxed form, the exclusion narrows the tax base and thus places upward pressure on marginal tax rates.

Proposal

The group legal exclusion would be allowed to expire.

Effective Date

Taxpayers have had notice that the group legal services exclusion would expire. It would be allowed to expire by its own terms.

Analysis

Expiration of the exclusion for group legal services will allow a market for such services to develop without tax-induced distortions.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED DEPENDENT CARE SERVICES

General Explanation

Chapter 3.05

Current Law

Dependent care assistance paid for or provided by an employer is excluded from the income of an employee if the assistance is provided under a plan meeting certain nondiscrimination and other requirements. Dependent care assistance is defined to mean the payment for, or provision of, household services for, or care of, an eligible dependent where such assistance enables the employee to be gainfully employed. Eligible dependents include (1) a dependent of the employee under the age of 15 with respect to whom the employee is entitled to a personal exemption, and (2) a dependent or spouse of the employee who is physically or mentally incapable of caring for himself. If the employee is not married, the amount excluded may not exceed the employee's earned income. If the employee is married, the amount excluded may not exceed the lesser of the earned income of the employee or of his spouse.

Dependent care expenses incurred by an individual maintaining a household are eligible for a tax credit. The credit equals the applicable percentage of amounts paid (up to the limits described below) for dependent care assistance. The applicable percentage is 30 percent reduced by one percentage point (but not below 20 percent) for each $2,000 by which the taxpayer's adjusted gross income exceeds $10,000. The amount subject to the credit in any year may not exceed $2,400 for one eligible dependent, or $4,800 for two or more eligible dependents. The amounts subject to the credit also may not exceed the employee's earned income or, in the case of a married couple, the lesser of the earned income of the employee or of the employee's spouse.

Dependent care assistance that is paid or provided by an employer and excluded from income is not eligible for the dependent care credit.

Reasons for Change

Dependent care expenses that enable a taxpayer to be gainfully employed constitute, at least in part, a business expense properly deductible from income. Although current law gives some recognition to the business component of dependent care expenses, the treatment of such expenses depends on whether they are financed by an employer or by the individual taxpayer. Dependent care services provided by an employer are excluded from income. Taxpayers who pay for such services themselves are eligible for a tax credit, which may be worth more or less to the taxpayer than a comparable exclusion.

There is no basis for the different tax treatment of employer-provided and individual-financed dependent care. In order to rationalize tax treatment of dependent care expenses, a deduction for certain dependent care expenditures should be available to all taxpayers. A proposal to that effect is presented in Chapter 2.05. Allowance of a deduction for dependent care expenses makes an exclusion of employer-provided dependent care inappropriate and unnecessary.

Finally, the exclusion makes it difficult to enforce the caps under the current credit (or the proposed dependent care deduction). Without repeal, expenses far above the caps (for very expensive child care) could be unfairly excluded in some cases.

Proposal

The exclusion for employer-provided dependent care would be repealed.

Effective Date

The repeal would be effective for taxable years beginning on or after January 1, 1986. There would be an exception, however, for assistance provided under a binding contract entered into prior to the date this proposal is introduced as legislation, until the earlier of January 1, 1989 or the date such contract expires or is renegotiated.

Analysis

Approximately 400 private employers, about three-quarters of which are hospitals, provide on-site dependent care centers. A few others provide care through vouchers, and a 1984 survey found 60 major employers offering dependent care as part of a cafeteria plan. In addition, the military provides subsidized care to at least 47,000 children.

Further growth in employer-provided dependent care assistance is expected, under current law, through cafeteria plans. Except in certain special cases (such as hospitals), these programs provide benefits to only a small fraction of employees, and therefore do not receive broad-based employee support outside of cafeteria plans. The Treasury Department proposals would repeal the exclusion of cafeteria plans. See Chapter 3.08.

Repeal of the dependent care exclusion should not adversely affect the income tax liabilities of most employees receiving such assistance since an offsetting deduction for dependent care expenditures would be available. See Chapter 2.05. Employers would still have an incentive to provide on-site dependent care services, or to contract for their provision, where they promote employee convenience or result in cost savings.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED COMMUTING SERVICES

General Explanation

Chapter 3.06

Current Law

The value of employer-provided commuting transportation is excluded from the income of employees if the transportation services are provided under a nondiscriminatory plan using vehicles that meet size and usage requirements. The exclusion is not available to self-employed individuals and is scheduled to expire for taxable years beginning after December 31, 1985.

Reasons for Change

As with most other fringe benefit exclusions, the exclusion of qualified transportation services from employee income is economically inefficient, inconsistent with horizontal equity principles, and a contributing factor in the high marginal rates of tax on taxable income. The qualified transportation exclusion is an inefficient mechanism to promote energy conservation since it targets only one form of group transportation, employer-provided van pools. This may cause taxpayers to reject possibly more effective but non-subsidized transportation alternatives. The exclusion is unfair because it is not available to all individuals and because, where available, it provides a greater benefit to high-bracket taxpayers.

Proposal

The exclusion from gross income of the value of employer-provided commuting transportation would be allowed to expire.

Effective Date

Taxpayers have had notice of the scheduled expiration of the van-pooling exclusion for taxable years beginning after December 31, 1985. It would be allowed to expire according to its terms.

Analysis

Expiration of the van-pooling exclusion will eliminate this unnecessary distortion.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

General Explanation

Chapter 3.07

Current Law

Up to $5,000 of employer-provided educational assistance is excluded from an employee's income if provided under a nondiscriminatory plan. Employers may either provide educational assistance directly or reimburse the employee for expenses. The education may not involve sports, games, or hobbies, and the assistance may not include payment for meals, lodging, transportation, or certain supplies.

The exclusion is currently scheduled to expire for taxable years beginning after December 31, 1985.

Educational expenses generally qualify as deductible business expenses if they are "job-related." Educational expenses which are not job-related and are not otherwise deductible are treated as non-deductible personal expenditures. Under current regulations, to be job-related, education must either: (1) maintain or improve skills required by the individual in his employment or other trade or business, or (2) meet the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation.

An employee may not deduct education expenses that are reimbursed by the employer if the reimbursement is excluded from income as employer-provided educational assistance.

Reasons for Change

Education is a national priority deserving broad public and private support. The exclusion from income of employer-provided educational assistance, however, is not an appropriate means of extending that support. The benefits of the exclusion are not fairly distributed since it is available only to employees in qualified plans. Even within the group of eligible employees, the exclusion is of greater value to high-income taxpayers. Finally, as an incentive provided through the Code, the educational assistance exclusion avoids the regular oversight and administrative controls that apply to direct budget expenditures.

Proposal

The exclusion of employer-provided educational assistance would be allowed to expire.

Effective Date

Taxpayers have had notice of the exclusion's expiration for taxable years beginning on or after January 1, 1986. It would be allowed to expire pursuant to its terms.

Analysis

Job-related educational expenditures are already deductible as ordinary and necessary business expenses, whether employer-provided or not. In general, repeal of the exclusion for employer-provided educational assistance would only affect those for whom the expense would not be deductible as a job-related expense; other employees would be able to offset the income with a corresponding business expense deduction.

There is no reason to believe that the education assistance exclusion of current law benefits primarily the groups for which it was intended -- minorities and the unskilled. The tax benefit is greatest for high-bracket taxpayers, and participation in adult education by those groups is relatively low.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED CAFETERIA PLANS

General Explanation

Chapter 3.08

Current Law

No amount may be included in the income of a participant in a "cafeteria plan" solely because the participant may choose among the benefits available through the plan. A cafeteria plan is a plan established by an employer for some or all of its employees under which employees may choose between two or more benefits consisting of cash and "statutory nontaxable benefits." The phrase statutory nontaxable benefits includes certain welfare benefits such as accident or health insurance and dependent care assistance. Cafeteria plan benefits may also include certain taxable benefits, including taxable group-term life insurance in excess of $50,000, and vacation days, if participants cannot cash out or use in a subsequent plan year any vacation days remaining unused at the end of the year.

The cafeteria plan exception to general constructive receipt rules does not apply to "highly compensated participants" if the plan discriminates in favor of "highly compensated individuals" as to eligibility or in favor of highly compensated participants as to contributions and benefits. In addition, the exception is not available to a "key employee" if the statutory nontaxable benefits (without regard to taxable group-term life insurance) provided to key employees exceed 25 percent of the aggregate of such benefits provided to all employees.

Reasons for Change

The cafeteria plan rules depart from general tax accounting principles, add complexity to the tax law, undermine the coverage rules generally applicable to nontaxable fringe benefits, and facilitate the provision of increased amounts of compensation as nontaxable fringe benefits. In the absence of the cafeteria plan rules, the "constructive receipt" doctrine would require that an employee with the right to choose between cash compensation and some nontaxable benefit be treated for tax purposes as having received the cash even though he chooses to receive the nontaxable benefit. In overriding the constructive receipt doctrine, the cafeteria plan rules disregard the fact that an employee who is entitled to receive cash but instead elects an in-kind benefit is in the same pre-tax economic position as a taxpayer who receives cash and purchases the benefit directly. The cafeteria plan rules result in different tax treatment of these similarly situated individuals.

By allowing employees to pick and choose among nontaxable fringe benefits, the cafeteria plan rules eliminate employee disagreement over the desirability of particular benefits as a limiting factor on the availability of such benefits. The rules thus effectively increase the percentage of compensation that employees receive in nontaxable forms.

The cafeteria plan rules also undermine the coverage and nondiscrimination requirements for statutory fringe benefits by permitting individual employees to decide whether they wish to receive a particular benefit. Generally, the rationale for excluding an employer-provided benefit from employees' income is to encourage the broadest extension of the particular benefit to employees on a nondiscriminatory basis. The cafeteria plan rules undercut this rationale, since they permit individual employees to elect cash over the benefit without affecting the tax treatment of other employees. In effect, the tax benefits are made available without regard to whether all employees receive the particular benefit on a broad, nondiscriminatory basis.

Proposal

The cafeteria plan exclusion would be repealed.

Effective Date

The repeal would generally be effective on and after January 1, 1986. There would be an exception, however, for cafeteria plans in existence after such date under a binding contract entered into prior to the date this proposal is introduced as legislation, until the earlier of January 1, 1989 or the date such contract expires or is renegotiated.

Analysis

If current law regarding fringe benefits remains unchanged, rapid growth in cafeteria plans is expected, further eroding the tax base. It is estimated that the number of employees covered under such plans (less than 1,000,000 in 1983) would rise to 25,000,000 by 1989. This would mean a rapid increase in the consumption of employer-provided nontaxable fringe benefits. The Treasury Department proposals, however, would repeal the exclusion of most statutory fringe benefits from income. With fewer nontaxable fringe benefits available for inclusion in cafeteria plans, the significance of cafeteria plan selectivity would be proportionately diminished.

REPEAL SPECIAL TREATMENT OF INCENTIVE STOCK OPTIONS

General Explanation

Chapter 3.09

Current Law

In general, a stock option granted by a corporate employer to an employee is subject to tax under statutorily prescribed rules applying to transfers of property in connection with the performance of services. Under these rules, if an employee receives an option with a readily ascertainable fair market value, such value (less the price paid for the option, if any) constitutes ordinary income to the employee when the employee becomes substantially vested in the option (i.e., the option either becomes transferable or ceases to be subject to a substantial risk of forfeiture). If an employee receives an option that does not have a readily ascertainable value, the option is not taxable to the employee; instead the employee is taxable on the stock received upon exercise of the option when the employee becomes substantially vested in such stock. Ordinary compensation income is recognized at that time equal to the difference between the option price and the value of the stock.

Current law provides an exception to the above general rules for certain "incentive stock options" granted to employees. If a stock option qualifies as an incentive stock option, the employee will realize no income upon receipt or exercise of the option. Moreover, gain upon sale of the stock acquired by exercise of the option will be taxed at capital gain rates, provided that (i) the employee does not transfer the stock within two years after the option is granted, and (ii) the employee holds the stock itself for one year. An employer may not claim a deduction with respect to an incentive stock option or stock transferred pursuant to such an option.

To qualify as an incentive stock option, the option must be granted pursuant to a plan approved by the corporation's shareholders. The plan must provide that an employee cannot be granted, in any one year, options to purchase more than $100,000 of stock plus any available carryover amount. An incentive stock option must carry an option price equal to the fair market value of the stock at the time the option is granted. An incentive stock option cannot be exercisable more than ten years from the date of its grant, and cannot be transferable (other than at death). In addition, an incentive stock option cannot be exercised while there is outstanding any other incentive stock option granted to the employee at an earlier date entitling the employee to purchase stock in the employer corporation, its parent, its subsidiaries, or a predecessor of any such corporation. Finally, unless certain special requirements are met, incentive stock options generally cannot be granted to employees who own, at the time of grant, stock possessing more than ten percent of the total combined voting power of the employer corporation or its parent or subsidiaries.

Reasons for Change

The special rules applicable to incentive stock options permit corporate employers to provide tax-preferred compensation to management personnel and other key employees. Thus, compensation attributable to incentive stock options not only is eligible for preferential capital gain treatment, but its inclusion in income is deferred from receipt or exercise of the option to the time the stock acquired pursuant to the option is sold. Although employers receive no deduction with respect to incentive stock options, differences in the marginal tax rates of corporations and their key employees would ordinarily produce a net tax savings.

The purpose of the incentive stock option provisions is to enable corporations to attract and retain key management employees. There is no substantial evidence, however, that stock options in themselves are more attractive to key employees than cash or other forms of compensation of equivalent value. Instead, the incentive feature of stock options under current law is their highly favorable tax treatment.

Because of the tax treatment of incentive stock options, recipients of such options are permitted to understate their income for tax purposes and thus to pay less tax than others in the same economic position. This Federal subsidy for typically affluent taxpayers would never survive as a direct budget expenditure, but depends upon concealment in the tax law. It is unfair not only to employees who do not receive such tax-preferred compensation, but also to the noncorporate employers that cannot issue stock options.

Proposal

The incentive stock option provisions would be repealed. All employer-provided stock options would thus be taxed under the general rules applicable to transfers of property in connection with the performance of services.

Effective Date

The proposal would apply to options granted on or after January 1, 1986, except options granted prior to the date the proposal is introduced as legislation.

Analysis

The impact of repeal would fall largely on the small class of key management employees who ordinarily participate in stock option plans. Since the Treasury Department proposals would eliminate the current preferential tax rate for long-term capital gain, see Ch. 9.01, repeal of the incentive stock option rules would only affect the time at which compensation income was reported.

REPEAL TAX EXEMPTION FOR VEBAs, SUB TRUSTS AND BLACK LUNG TRUSTS

General Explanation

Chapter 3.10

Current Law

In general, the year in which an employer may deduct compensation provided to its employees, either in the form of cash or welfare benefits, corresponds to the year in which the employees include (or, but for an exclusion, would include) the compensation in income. In addition, if an employer prefunds its obligations to pay future employee compensation, income earned on the amounts set aside for that purpose is taxable to the employer.

In certain circumstances, the tax law has permitted an employer more favorable treatment for amounts set aside to prefund future compensation obligations. In such cases, the employer has been allowed a current deduction for contributions to a reserve for future compensation, and the reserve has been permitted to grow on a tax-exempt basis. With respect to compensation paid in cash, this favorable treatment generally has been available only with respect to profit-sharing and pension plans that comply with various qualification rules, such as nondiscrimination rules, minimum standards relating to participation, vesting, benefit accrual, and funding, and annual limits on contributions and benefits. With respect to compensation provided in the form of welfare benefits, the favorable tax treatment has been available for contributions to welfare benefit funds, such as voluntary employees' beneficiary associations (VEBAs), supplemental unemployment compensation benefit (SUB) trusts, and black lung trusts. Thus, subject to certain limitations, employers are able to deduct currently contributions to VEBAs, SUB trusts, and black lung trusts which fund future employee benefits such as health care and unemployment or disability compensation. In general, investment income earned by these associations and trusts is exempt from tax. Unlike qualified pension plans, VEBAs, SUB trusts and black lung trusts are not subject to mimimum standards for funding, participation and benefit accrual, or to annual limits on benefits.

Beginning in 1986, new rules adopted in the Tax Reform Act of 1984 will govern an employer's deduction for contributions to VEBAs, SUB trusts, and other welfare benefit funds and will limit the extent to which the income of such associations, trusts, and funds will be tax-exempt. (Black lung trusts are not affected by the new rules.) Under the new rules, amounts set aside to provide post-retirement life insurance up to $50,000 to retired employees and to make disability payments to disabled employees will be permitted to continue to grow on a tax-exempt basis. In addition, amounts set aside in one year to cover claims incurred during that year will be permitted to grow on a tax-exempt basis. Finally, subject to various limits, amounts still may be set aside on a tax-exempt basis to provide for future unemployment compensation.

Reasons for Change

The tax benefit of tax-exempt growth for amounts set aside to fund deferred compensation should generally not be available outside of the qualified retirement plan area. Although the rules adopted in the Tax Reform Act of 1984 will limit the type and levels of benefits for which an employer may prefund on a tax-favored basis, the advantage of tax-exempt growth remains for certain benefits within the specified limits. This exemption of investment income from tax effectively shifts a portion of the cost of employee compensation to the general public.

In addition, continuation of the exemption would be inconsistent with the tax treatment of reserves for welfare benefits under a policy with an insurance company. The Treasury Department proposals include taxation of the income on reserves held by casualty insurance companies. See Ch. 12.05. In order not to provide more favorable tax treatment to self-insured benefit arrangements than to insured arrangements, the income earned by VEBAs, SUB trusts, and black lung trusts should similarly be subject to tax.

Proposal

The tax exemption for VEBAs, SUB trusts, and black lung trusts would be repealed.

Effective Date

The repeal would apply for taxable years of the VEBAs, SUB trusts, and black lung trusts beginning on or after January 1, 1986.

Analysis

Although the proposal would subject the income of VEBAs, SUB trusts, and black lung trusts to tax, the existing rules governing employer deductions for contributions to these associations and trusts would not be altered. Thus, to the extent permitted under current law, an employer would be able to continue to deduct contributions to these organizations.

REPEAL EXCLUSION FOR EMPLOYEE AWARDS

General Explanation

Chapter 3.11

Current Law

Gifts are excluded from the gross income of the donee. Whether an employer's award to an employee constitutes taxable compensation or a gift excludable from gross income depends upon the facts and circumstances surrounding the award.

If an employee award is excludable from income as a gift, the amount that can be deducted by the employer is limited by statute. In general, the cost of a gift of an item of tangible personal property awarded to an employee by reason of length of service, productivity or safety achievement may not be deducted by the employer to the extent that it exceeds $400. In the case of an award made under a permanent, written plan which does not discriminate in favor of officers, shareholders or highly compensated employees, gifts of items with a cost up to $1600 may be deducted, provided that the average cost of all items awarded under all such plans of the employer does not exceed $400.

The fact that an award does not exceed the dollar limitations on deductions has no bearing on whether the award constitutes taxable compensation to the employee; in all cases that issue depends on the facts and circumstances surrounding the award. Nevertheless, many taxpayers take the position that if the dollar limitations are not exceeded, the award automatically constitutes a gift and is excludable from the employee's income.

Reasons for Change

A gift for tax purposes is a transfer of property or money attributable to detached and disinterested generosity, motivated by affection, respect, admiration, or charity. The on-going business relationship between an employer and employee is generally inconsistent with the disinterest necessary to establish a gift for tax purposes. Moreover, in the unusual circumstances where an employee award truly has no business motivation, it cannot consistently be deducted as an ordinary and necessary expense of the employer's business.

Current law not only allows employee awards to be characterized as gifts but provides a tax incentive for such characterization. The amount of an employee award treated as a gift is excluded from the income of the employee, and the employer may nevertheless deduct the award to the extent it does not exceed certain dollar limits. Even to the extent an award exceeds those limits, gift characterization produces a net tax advantage if the employee's marginal tax rate exceeds that of the employer.

Current law also generates substantial administrative costs and complexity by requiring the characterization of employee awards to turn on the facts and circumstances of each particular case. The dedication of Internal Revenue Service and taxpayer resources to this issue is inappropriate, since relatively few employee awards represent true gifts and since the amounts involved are frequently not substantial.

Proposal

Gift treatment would generally be denied for all employee awards of tangible personal property. Such awards would ordinarily be treated as taxable compensation, but in appropriate circumstances would also be subject to dividend or other non-gift characterization. It is anticipated that a de minimis award of tangible personal property would be excludable by the employee under rules of current law concerning de minimis fringe benefits.

Effective Date

The proposal would be effective for awards made on or after January 1, 1986.

Analysis

Available data concerning employee awards of tangible personal property is incomplete. Surveys indicate that businesses made gifts to employees totalling approximately $400 million in 1983. It is unclear what portion of these gifts were in the form of tangible personal property; however, the majority of these gifts were less than $25 in value. Less than ten percent of all employees are covered by an employer plan for such benefits. Thus, the proposal would affect few employees and would promote horizontal equity.

REPEAL EXCLUSIONS FOR MILITARY ALLOWANCES

General Explanation

Chapter 3.12

Current Law

Most military personnel and members of other uniformed services receive tax-free cash allowances for quarters and subsistence in addition to their taxable basic pay. The exclusion from income of military housing and subsistence allowances stems from an early decision of the courts and is now codified in Treasury regulations and Federal statutes governing military compensation.

Compensation received by members of the armed forces while serving in a combat zone or while hospitalized for combat-related injuries is excluded from income. In the case of a commissioned officer, the amount of this exclusion is limited to $500 per month. Current law also provides for complete forgiveness of income tax for servicemen dying while in active service in a combat zone or as a result of wounds, disease, or injury incurred while so serving. The forgiveness applies to the year of death and prior years ending on or after the serviceman's first day of service in a combat zone. A similar forgiveness of income tax is available to military and civilian employees of the United States who die as a result of wounds or injury incurred outside the United States in a terroristic or military action.

Amounts received by a member of the uniformed services as a pension, annuity or similar allowance for combat-related injuries or a veteran's disability also are excluded from income. A further exclusion is provided for mustering-out payments to members of the armed services.

Reasons for Change

Military personnel should be compensated fairly for their work and sacrifices. It is especially appropriate that the nation provide for those who have been injured or killed in the service of their country, as well as for their survivors. The provision of a portion of military compensation in the form of tax benefits, however, interferes with the budget process. Decisions concerning the form and amount of direct military compensation cannot be made intelligently unless the full revenue costs are understood. Current tax exemptions disguise these costs.

The provision of a portion of compensation in the form of tax benefits is not a fair substitute for additional taxable compensation. The tax benefit of an exclusion from income or a forgiveness of tax is disproportionately greater for those with higher incomes and higher marginal tax rates. The current forms of tax relief for the military thus discriminate in favor of high-income over low-income members of the military. Tax revenue lost as a result of tax relief for the military reduces the level of direct compensation that the nation can afford to pay. Thus, the cost of tax relief is borne by all members of the military, even though it disproportionately benefits those with higher incomes. Increasing basic pay and other direct compensation is the fairest method of compensating military personnel.

Proposal

Compensation received by members of the uniformed services generally would be subject to Federal income tax under the same principles applicable to civilian employees. Thus, cash allowances for quarters and subsistence would be includible in gross income. In-kind allowances also would be subject to taxation, but meals and lodging provided on military premises would be excluded from income if the convenience of the employer standard of current law is satisfied.

The exclusion from income of combat-related compensation would be repealed. The exclusion from income of allowances for combat-related injuries and disablility compensation also would be repealed. However, such allowances, as with disability income of civilian workers generally, would be eligible for the credit for the elderly, blind and disabled. See Ch. 2.02. Finally, the current forgiveness of income tax for servicemen and other employees of the United States dying as a result of terroristic or military action outside the United States would be repealed, along with the exclusion for mustering-out pay.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1987.

Analysis

It is expected that, through the regular budget process, military pay and allowance schedules would be adjusted to reflect the taxation of previously tax-free allowances. Thus, on average, servicemen and women would not suffer a reduction in after-tax compensation.

The proposed changes generally would make the taxation of military compensation equivalent to the taxation of compensation in other areas in the economy. Thus, regular cash and in-kind compensation of members of the military would be taxable under the same general principles that apply to civilian employees. In addition, similar treatment of injury and disability wage-based compensation would be provided for military and civilian employees. Thus, the current exclusion for military disability compensation would be repealed, consistent with the Treasury Department proposal to include civilian worker's compensation in income. See Chapter 3.14.

The delayed effective date should provide ample time for adjustments in military compensation.

REPEAL EXCLUSION FOR PARSONAGE ALLOWANCES

General Explanation

Chapter 3.13

Current Law

Employer-provided housing is generally taxable compensation to an employee unless the housing is on the business premises of the employer, must be accepted as a condition of employment, and is provided for the convenience of the employer. Under current law, however, a minister does not include in his gross income the rental value of a home furnished as part of his compensation. Cash rental allowances, to the extent used to rent or obtain a home, also are excluded from a minister's income.

Reasons for Change

The exclusion from income of parsonage allowances departs from generally applicable income measurement principles, with the result that ministers pay less tax than other taxpayers with the same or even smaller economic incomes. Thus, a minister with a salary of $18,000 and a $6,000 cash housing allowance is in the same economic position and has the same ability to pay tax as a taxpayer (such as a teacher) earning $24,000 in taxable income and spending $6,000 on housing. The tax liability of the minister is considerably less, however, due to the current exclusion from taxable income of the parsonage allowance. Further, as with other deviations from income measurement principles, the exclusion of parsonage allowances narrows the tax base and places upward pressure on marginal tax rates.

There is no evidence that the financial circumstances of ministers justify special tax treatment. The average minister's compensation is low compared to other professions, but not compared to taxpayers in general. Moreover, the tax benefit of the exclusion provides a disproportionately greater benefit to relatively affluent ministers, due to the higher marginal tax rates applicable to their incomes.

Proposal

The income exclusion for parsonage allowances would be repealed. Ministers would include in their gross income any cash housing allowance. The fair market rental value of employer-provided housing would also be taxable unless it met the convenience of the employer standard of current law.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1987.

Analysis

Repeal of the exclusion for parsonage allowances would reduce the after-tax income of the more than 140,000 ministers who receive housing or housing allowances if no compensatory adjustment in salary is made. Current salary levels for ministers often reflect the favorable treatment of parsonage allowances. It may be expected that, in many cases, salaries would be adjusted to take account of repeal of the exclusion for parsonage allowances, so that ministers' after-tax incomes would not be significantly affected.

In some cases, however, particularly where the work of a minister is identical to that of a non-minister (such as teaching in religious schools), no compensating increase in salary is likely. These cases, however, provide the clearest examples of how current law provides different treatment for taxpayers with the same economic income.

Taxing cash housing allowances is administratively easy. Taxing employer-provided housing, however, will require determination of whether the housing may be excluded from income under the current law convenience of the employer standard, and, if not, an estimation of the fair market rental value of such housing. These determinations involve some administrative costs and taxpayer burdens, but they are no different than those required in other cases where employees receive housing or other taxable in-kind compensation from their employers.

The delayed effective date should provide sufficient time for readjustments of compensation arrangements in which ministers currently receive tax-free housing either in kind or through rental allowances.

Part B. Excluded Sources of Income--Wage Replacement Payments

REPEAL EXCLUSON FOR UNEMPLOYMENT AND DISABILITY PAYMENTS

General Explanation

Chapter 3.14

Current Law

In general, any cash wage or salary compensation received by an employee is fully includible in the employee's income. Under current law, however, payments under a variety of programs designed to replace wages lost due to unemployment or disability are fully or partially exempt from tax.

Unemployment Compensation. If the sum of a taxpayer's adjusted gross income (determined without regard to certain Social Security and railroad retirement benefits and the deduction for two-earner married couples) and his unemployment compensation is less than a "base amount" ($12,000 for single returns and $18,000 for joint returns), unemployment compensation will be totally excluded from gross income. If such sum exceeds the base amount, then the taxpayer's gross income will include the lesser of (i) one-half of such excess, or (ii) all of the taxpayer's unemployment compensation.

Thus, for example, if a married couple filing a joint return receives $8,000 in unemployment compensation and has no other income, the unemployment compensation will be totally excluded from gross income. On the other hand, if the couple has $18,000 of other income, one-half of the unemployment compensation will be included in their gross income. As income other than unemployment compensation increases, a greater percentage of unemployment compensation will be included (up to 100 percent if their other income equals or exceeds $26,000).

Disability Compensation. Workers' compensation payments as well as black lung benefits to disabled coal miners are fully excluded from income. In addition, under statutory provisions outside the tax code, all benefits provided under laws administered by the Veterans' Administration are exempt from tax.

Net Replacement Rates. Most wage replacement programs pay benefits equal to a flat percentage of gross earnings, subject to minimum and maximum dollar limits. Although this percentage is generally stated as a gross replacement rate, the effect of a wage replacement program can be determined only by analyzing its "net replacement rates" -- the fraction of a worker's lost after-tax wages that the program replaces. Exclusion of wage replacement payments from income causes a program's net replacement rate to exceed its gross replacement rate. Assume, for example, that Individual A would have earned $25,000 last year and would have paid taxes of $5,000, leaving after-tax income of $20,000. If A is disabled and receives one-half of his gross earnings ($12,500) in tax-free wage replacement payments, the 50 percent gross replacement rate results in a 62.5 percent net replacement rate, since $12,500 is 62.5 percent of $20,000.

Reasons for Change

Fairness. The fairness of a wage replacement system must be examined in terms of net rather than gross wage replacement rates, since it is the net replacement rate that indicates what percentage of the individual's true loss in wage income has been restored. The current exclusion of wage replacement benefits from income typically causes net replacement rates to exceed gross replacement rates. Moreover, this excess increases with the tax rate of the recipient's family.

Assume, for example, that individuals A and B have identical jobs and that each earns $160 per week. Due to disability or unemployment, both suffer a loss of all wages, and each receives a payment of $80 per week. Although each has a gross replacement rate of 50 percent, their net replacement rates may differ greatly. If A has several dependents and no other source of income, he would have paid no income tax on his $160 per week; thus his net replacement rate equals his gross replacement rate of 50 percent. On the other hand, if B's spouse has substantial earnings so that the family is in the 30 percent tax bracket, B's net replacement rate will exceed 70 percent because his $80 tax-free payment has replaced after-tax income of $112.

As illustrated by a comparison of net replacement rates, the exclusion of wage replacement payments from income under current law provides the greatest benefit to single taxpayers with no dependents and to taxpayers with other sources of income. Correspondingly, current law provides the least benefit to taxpayers with several dependents and no other source of income. Moreover, the exclusion generally results in higher net replacement rates for those unemployed or disabled for short periods than for those suffering from long-term unemployment or disability.

The current disparity in net replacement rates could be redressed by redesigning wage replacement programs to take total family income into account. This solution, however, would add greatly to administrative complexity. A more efficient approach would be to tax wage replacement payments, recognizing that payment schedules could also be adjusted to maintain average net replacement rates. This would ensure comparable net replacement rates for individuals receiving benefits under the same programs.

Work Incentives. Any wage replacement program will reduce work incentives by reducing the net gain from returning to work. This effect is greatest when such payments are nontaxable, since net wage replacement rates then increase with family income. For example, if a 66 percent net replacement rate is desired for low-income families, it will be necessary to provide a 66 percent gross replacement rate for low-wage workers. Unless benefit payments are based on need, however, a 66 percent gross replacement rate may result in net replacement rates in excess of 100 percent for low-wage workers from high-income families.

Such high replacement rates are clearly undesirable. However, as long as payments are nontaxable and are not based on need, any increase in the net replacement rates for low-income families will create extremely high net replacement rates for low-wage workers from wealthier families. With respect to unemployment compensation, taxing an increasing percentage of unemployment compensation as the recipient's income increases above his "base amount" creates peculiar work disincentives. For example, if a married individual receives $5,000 in unemployment compensation, each additional dollar that the individual or his or her spouse earns between $13,000 and $23,000 will require inclusion in their gross income of another $0.50 of the unemployment compensation. In effect, each additional dollar of earned income within that range increases their taxable income by $1.50, and thereby multiplies their marginal tax rate by 1.5 for each dollar of earned income within that range. Such perverse results are inevitable if such a threshold is used.

The conflict between minimum replacement rates and work incentives is greatly reduced if benefits are taxed, even if the average net replacement rate is maintained through higher payments.

Neutrality. Wage replacement payments are presumably reduced in recognition that they are nontaxable, thereby reducing the cost of funding such programs. If the programs are paid for by employers (either through insurance or taxes), exclusion provides an indirect subsidy to industries with high injury or layoff rates, and indirectly raises tax rates on other income. Since the costs of job-related injuries and anticipated layoffs is a real cost of production, this subsidy distorts market prices and resource allocation. Although neutrality could also be achieved by treating wage replacement programs as insurance and taxing employees on the "premiums" paid by employers, this would be administratively difficult and would do nothing to reduce the problems of fairness or work disincentives discussed above.

The exclusion from taxation may also hide the true cost of government-mandated programs from the policymakers who determine their scope and size. Taxing wage replacement payments would enable policymakers to make more informed decisions.

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Proposal

All unemployment compensation would be included in income.

In addition, all cash payments for disability from workers' compensation, black lung, and veterans' programs would be included in income, except for payments for medical services (unless previously deducted), payments for physical and vocational rehabilitation, burial fees, and non-service related veterans' disability payments.

The Treasury Department proposals include an expanded credit for the elderly, blind, and disabled. See Chapter 2.02. In order to protect low- and moderate-income disabled taxpayers, the proposal would make all taxable disability payments (up to $6,000 for individual returns and $9,000 for joint returns) eligible for a 15 percent tax credit. The amount eligible for the credit would be reduced by any Title II social security benefits and by one-half of the excess of adjusted gross income over $7,500 ($10,000 for joint returns).

Effective Dates

The proposal would apply to all unemployment compensation received on or after January 1, 1987.

With respect to workers' compensation payments, the proposal would apply to all payments received by employees or their survivors for disabilities occurring on or after January 1, 1987. Payments received for a disability occurring before such date would remain nontaxable.

The proposal would apply to all black lung and veterans' service-related disability payments received on or after January 1, 1987, regardless of the date on which the disability occurred.

Analysis

In General. Taxing wage replacement payments would eliminate the disparities in net replacement rates under current law. It would thus be possible to replace 50 percent of lost wages for workers in low-income families without providing net replacement rates far above that rate for workers from families with substantial income from other sources. This would enable wage replacement programs to target the benefits to those who need them most.

Unemployment Compensation. Most unemployment compensation is now excluded from gross income. In 1982, only one-third of such payments was taxed. Of $20.6 billion in payments, only $7 billion were included in gross income. Over $3.8 billion was received by taxpayers with adjusted gross incomes between $18,000 and $30,000, more than 30 percent of which was excluded from gross income.

Most unemployment compensation is received by families with other sources of income. In addition, most unemployed individuals remain unemployed for less than 15 weeks, so their unemployment compensation supplements income from employment during the rest of the year. Under such circumstances, the exclusion of unemployment compensation from income provides an unnecessary and unfair tax advantage. For example, a married person earning $15,000 during the year and receiving $3,000 in unemployment compensation now pays substantially less tax than someone working all year and earning $18,000.

Any unemployment compensation program will necessarily create some work disincentives. The proposal, however, would eliminate the peculiar disincentives created by the threshold for taxing such benefits under the current system.

States may wish to adjust their unemployment compensation programs if all such compensation is included in gross income. A State that pays benefits equal to 50 percent of gross wages will provide net replacement rates of less than 50 percent to most unemployed workers. The Treasury Department proposals include increased personal exemptions and zero bracket amounts, along with lower tax rates. As a consequence, most workers who are unemployed for a long time and have little access to other sources of income would pay little or no tax on their benefits. The proposed effective date would provide time, however, for States to adjust benefits to protect even more workers.

Disability Payments. By combining all special treatment for the disabled in a single tax credit, the proposal would ensure that preferential treatment for the disabled is provided in a fair and consistent manner. Persons receiving workers' compensation, black lung, and service-related veterans' disability payments would be treated similarly to persons who are disabled and receive disability pay from an employer. In both cases, the tax-exempt level of income for a single person who is disabled for the entire year and depends mostly on such disability payments would be $9,700. For a family of four, the tax-exempt level would be $17,200. These tax-exempt levels are substantially in excess of the tax-exempt levels applicable to other taxpayers ($4,800 for single returns; $11,800 for families of four). In approximately 80 percent of the States, a family of four solely dependent on workers' compensation would pay no Federal income tax even if it received the maximum payment under that State's program.

Table 1

Distribution of Workers' Compensation Payouts

Family Economic Income	Percentage of All Families	Percentage of Cash Payments From Workers' Compensation
$ 0 - 10,000	15.0	4.1
10,000 - 15,000	12.7	7.4
15,000 - 20,000	11.7	8.3
20,000 - 30,000	19.3	22.2
30,000 - 50,000	23.3	33.7
50,000 - 100,000	15.4	22.4
100,000 - 200,000	2.1	1.3
200,000 and above	0.5	0.4
	100.0	100.0

Office of the Secretary of The Treasury November 30, 1984
Office of Tax Analysis

As illustrated in Table 1, workers' compensation benefits are received primarily by middle- and upper-income taxpayers. This is largely attributable to the fact that most of those receiving workers' compensation are off work for less than three weeks (with less than one percent permanently and totally disabled), and benefits are related to wage levels. Since each dollar of excluded income is worth more to those in higher tax brackets, the tax benefits from current law are concentrated among higher income families. The higher tax-free threshold would ensure that no families below the poverty line are taxed on income from any source.

Despite the extensive protection the proposal provides for the low- and moderate-income disabled, the taxation of these forms of disability income generates substantial revenue which can be used to reduce tax rates on other income.

The repeal of the exclusion is delayed until 1987 to allow the State and the Federal governments to make any desired compensatory changes in their benefit schedules. Moreover, in the case of workers' compensation, the repeal would apply only to those receiving workers' compensation for disabilities occurring on or after January 1, 1987. Since most workers' compensation payments are made by private insurance companies, payments for past injuries are funded from premiums paid in the past. As a result, there is no easy way to adjust such payments for the change in tax status. No such grandfathering is proposed for the two Federal programs (black lung and veterans' service-related disability) because those payments can be adjusted, if desired, for all beneficiaries.

The exception for non-service-related disability payments is justified by the nature of that program, which is most accurately categorized as a welfare program. Benefits are small and strictly based any other source. Such means-tested payments are generally excluded from gross income. Moreover, the criteria for such payments would ensure that no recipient of these veterans' benefits would pay income tax even if such benefits were made fully taxable.

Part C. Excluded Sources of Income--Others

LIMIT SCHOLARSHIP AND FELLOWSHIP EXCLUSION

General Explanation

Chapter 3.15

Current Law

Current law provides an exclusion from income for the amount of certain scholarships or fellowship grants. In the case of candidates for a degree at an educational organization with a regular faculty, curriculum and enrolled body of students, any scholarship or fellowship grant is excludable unless it represents compensation for services. If teaching, research, or other services are required of all such degree candidates, a scholarship or fellowship grant is not regarded as compensation for such services.

Nondegree candidates may exclude scholarships or fellowship grants only if the grantor is a charitable organization, a foreign government or an international organization, or an agency of the United States or a State. The amount that may be excluded is limited to $300 per month, with a lifetime maximum of 36 months. This limit does not apply, however, to amounts received to cover expenses for travel, research, clerical help, or equipment, which are incident to the scholarship or the fellowship grant ("incidental expenses").

Compensation for past, present, or future services is generally not treated as a scholarship or as a fellowship grant. However, in addition to the special rule for degree candidates, there is an exception for certain amounts received under a Federal program. These amounts are treated as scholarships even though the recipient must agree to perform future services as a Federal employee as a condition of obtaining the scholarship.

Reasons for Change

Scholarships and fellowship grants confer a benefit on the recipient that should be taxed as income. The full exclusion of these benefits from income under current law is unfair to the ordinary taxpayer who must pay for education with earnings that are subject to tax.

In theory, it might be appropriate to include the full amount of any scholarship in income. In practice, this would create real hardships for many scholarship recipients. Scholarship awards are often made on the basis of need. If students were taxed on such amounts, they would often not have the resources to pay the tax. Moreover, unlike most cases in which in-kind benefits are subject to tax, the recipient of a scholarship is not receiving an in-kind benefit in lieu of a cash amount and does not otherwise have the ability to convert the in-kind benefit to cash. The definition of income for tax purposes is appropriately limited by considerations of ability to pay. Accordingly, income from a scholarship for tax purposes should, in general, be limited to amounts that represent out-of-pocket savings for regular living expenses.

An exception for incidental expenses of nondegree candidates is also appropriate. Such expenses would typically be deductible as ordinary and necessary business expenses, and thus in most cases an exclusion simply provides an equivalent tax result.

Proposal

Scholarships and fellowship grants generally would be includible in gross income. In the case of degree candidates, scholarships would be excludable to the extent that they were required to be, and in fact were, spent on tuition and equipment required for courses of instruction. In the case of nondegree candidates, reimbursements for incidental expenses (as defined in current law) would be excludable.

The special rules concerning performance of future services as a Federal employee and compensation for services required of all degree candidates would be repealed.

Effective Date

The proposal generally would be effective with respect to scholarships and fellowships received on or after January 1, 1986. However, if a binding commitment to grant a scholarship in the case of a degree candidate was made before January 1, 1986, amounts received pursuant to such commitment would be excludable under the current-law rules through the end of 1990.

Analysis

The proposal generally would tax scholarships and fellowship grants in the same manner as other income. For degree candidates, amounts granted to cover room and board or other living expenses would be taxable. Students receiving scholarships that were used for tuition and fees would not be liable for tax by reason of the award. Moreover, even students receiving scholarship amounts for expenses other than tuition and fees would not pay tax as a result of the award where the student's total income is less than the sum of the zero bracket amount and the personal exemption ($4,800 if single, and $7,800 for a married couple filing jointly).

REPEAL EXCLUSION FOR PRIZES AND AWARDS

General Explanation

Chapter 3.16

Current Law

In general, the amount of a prize or award is includible in income on the same basis as other receipts of cash or valuable property. Current law provides an exception to this general rule, however, for prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. To qualify for this exclusion, the recipient of the prize or award must be selected without any action on his or her part to enter the contest or proceeding, and must not be required to render substantial future services as a condition of receiving the prize or award.

Reasons for Change

Prizes or awards increase an individual's ability to pay tax the same as any other receipt that increases an individual's economic wealth. In effect, the failure to tax all prizes and awards creates a program of matching grants under which certain prizes or awards also bestow the government-funded benefit of tax relief. Basing this program in the tax code permits it to escape public and legislative scrutiny and causes benefits to be distributed not according to merit but to the amount of the tax the individual would otherwise owe.

Proposal

The amount of any prize or award received by a taxpayer would be fully includible in income, regardless of whether for religious, charitable, scientific, educational, artistic, literary, or civic achievement. The rule of current law would continue to apply, however, to the extent that the individual recipient of a prize or award designated that such prize or award go to a tax-exempt charitable organization.

Effective Date

The proposal would be effective for prizes and awards received on or after January 1, 1986.

Analysis

Repeal of the exclusion for certain prizes and awards will affect the tax liability of only a few taxpayers, but it will reduce the complexity of the tax laws and preclude attempts to characterize income as a tax-exempt award.

Part D. Preferred Uses of Income

The Treasury Department proposals would curtail itemized deductions for certain personal exenditures, in order to broaden the tax base, simplify compliance and administration, and allow rates to be reduced. The deduction for State and local taxes would be phased out, and the charitable contribution deduction would be eliminated for nonitemizers and limited for itemizers. The deductions for medical expenses, casualty losses, and principal-residence mortgage interest would be left unchanged. Changes to the itemized deduction for intrest expense deduction are described in Chapter 9.03 (indexing) and Chapter 16.01 (limit on interest deduction). The deduction for miscellaneous expenses would be replaced with an adjustment to income. (See Chapter 4.03).

REPEAL DEDUCTION OF STATE AND LOCAL TAXES

General Explanation

Chapter 3.17

Current Law

Individuals who itemize deductions are permitted to deduct certain State and local taxes without regard to whether they were incurred in carrying on a trade or business or income-producing activity. The following such taxes are deductible:

- o State and local real property taxes.
- o State and local personal property taxes. (In some States, payments for registration and licensing of an automobile are wholly or partially deductible as a personal property tax.)
- o State and local income taxes.
- o State and local general sales taxes.

Other State and local taxes are deductible by individuals only if they are incurred in carrying on a trade or business or income-producing activity. This category includes taxes on gasoline, cigarettes, tobacco, alcoholic beverages, admission taxes, occupancy taxes and other miscellaneous taxes. Taxes incurred in carrying on a trade or business or which are attributable to property held for the production of rents or royalties (but not other income-producing property) are deductible in determining adjusted gross income. Thus, these taxes are deductible by both itemizing and nonitemizing taxpayers. Taxes incurred in carrying on other income-producing activities are deductible only by individuals who itemize deductions. Examples of these taxes include real property taxes on vacant land held for investment and intangible personal property taxes on stocks and bonds. State and local income taxes are not treated as incurred in carrying on a trade or business or as attributable to property held for the production of rents or royalties, and therefore are deductible only by individuals who itemize deductions.

Reasons for Change

The current deduction for State and local taxes in effect provides a Federal subsidy for the public services provided by State and local governments, such as public education, road construction and repair, and sanitary services. When taxpayers acquire similar services by private purchase (for example, when taxpayers pay for water or sewer services), no deduction is allowed for the expenditure. Allowing a deduction for State and local taxes simply permits taxpayers to finance personal consumption expenditures with pre-tax dollars.

Many of the benefits provided by State and local governments, such as police and fire protection, judicial and administrative services, and public welfare or relief, are not directly analagous to privately purchased goods or services. They nevertheless provide substantial personal benefits to State and local taxpayers, whether directly or by enhancing the general quality of life in State and local communities. Arguably, some individuals receive greater benefit from these services than others, but they are generally available on the same basis to all. Moreover, they are analagous to the services provided by the Federal government, and yet no deduction is allowed for the payment of Federal income taxes.

It is argued by some that State and local taxes should be deductible because they are not voluntarily paid. The argument is deficient in a number of respects. First, State and local taxes are voluntary in the sense that State and local taxpayers control their rates of taxation through the electoral process. Recent State and local tax reduction initiatives underline the importance of this process. Just as importantly, taxpayers are free to locate in the jurisdiction which provides the most amenable combination of public services and tax rates. Taxpayers have increasingly "voted with their feet" in recent years by moving to new localities to avoid high rates of taxation. Indeed, taxpayers have far greater control over the amount of State and local taxes they pay than over the level of Federal income taxes. Nevertheless, Federal income taxes are nondeductible.

The subsidy provided through the current deduction for State and local taxes is distributed in an uneven and unfair manner. Taxpayers in high-tax States receive disproportionate benefits, while those in low-tax States effectively subsidize the public service benefits received by taxpayers in neighboring States. Even within a single State or locality, the deduction of State and local taxes provides unequal benefits. Most State and local taxes are deductible only by taxpayers who itemize, and among itemizers, those with high incomes and high marginal tax rates receive a disproportionate benefit.

Finally, the deduction for State and local taxes is one of the most serious omissions from the Federal income tax base. Repeal of the deduction is projected to generate $33.8 billion in revenues for 1988. Unless those revenues are recovered, the rates of tax on nonexcluded income will remain at their current unnecessarily high levels.

Proposal

The itemized deduction for State and local income taxes and other taxes that are not incurred in carrying on a trade or business or income-producing activity would be phased out over a two-year period. For taxable years beginning on or after January 1, 1986, only 50 percent of such taxes would be deductible. For taxable years beginning on or after January 1, 1987, no portion of such taxes would be deductible. State and local taxes (other than income taxes) which currently are deductible only by itemizers, but which are incurred in carrying on an income-producing activity, would be aggregated with employee business expenses and other miscellaneous deductions and would be deductible subject to a threshold. See Ch. 4.03.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986, subject to the transitional rules described above.

Analysis

State and local taxes are the cost paid by citizens for public services provided by State and local governments, such as public schools, roads, and police and fire protection. For the one-third of all families that itemize deductions, these public services are purchased with pre-tax dollars.

Table 1 shows the distribution of families that itemize deductions for State and local taxes. While one-third of all families itemized deductions in 1983, most high-income families itemized (95 percent of families with incomes over $100,000) while there were relatively few itemizers among lower-income families. Two-thirds of the total deductions for State and local tax payments were claimed by families with economic incomes of $50,000 or more. The benefits of the deduction are even further skewed toward high-income families because deductions are worth more to families with higher marginal tax rates.

Because income levels vary across the country, taxpayers in various States make differing use of itemized deductions and pay different marginal tax rates. That is, residents of high-income, high-tax States make more use of itemized deductions than do residents of low-income, low-tax States. Under current law, the Federal government underwrites a greater share of State and local government expenditures in high-income and high-tax States than in low-income and low-tax States. Table 2 shows the States ranked on the basis of per capita incomes and the percent of returns with itemized deductions.

The three most important sources of State and local tax revenue in the United States are the general sales tax, the personal income tax, and the property tax. There may be a tendency to believe that itemized deductions should be eliminated for some of these taxes, but retained for others. The degree of reliance on these three tax bases, however, varies widely from State to State, as shown in Table 3. For example, 97 percent of the revenue that New Hampshire derives from these three tax bases came from property taxes, while Louisiana relies primarily on sales taxes (69 percent) and Delaware on income taxes (73 percent). Allowing itemized deductions for some of these revenue sources but not others would unfairly benefit the residents of the State policy decisions at the State and local level away from the nondeductible revenue source, just as current law discourages localities from using nondeductible fees and user charges.

Table 1

Distribution of Deductions for Taxes Paid
by Economic Income - 1983

Family Economic Income	Number of Families (thousands)	Percent with State and Local Deduction	State and Local Taxes Deducted 1/ ($millions)	Average Amount Deducted 2/
$ 0 - 9,999	337	2	$ 233	$ 691
10,000 - 14,999	516	4	465	901
15,000 - 19,999	1,009	9	1,009	1,089
20,000 - 29,999	3,894	22	5,307	1,363
30,000 - 49,999	10,820	51	22,012	2,034
50,000 - 99,999	11,298	80	36,408	3,223
100,000 - 199,999	1,793	95	12,150	6,776
200,000 or more	426	97	9,090	21,338
Total	30,093	33	$ 86,762	$ 2,883

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1/ Net of income tax refunds.

2/ For families tht itemize deductions.

Source: Treasury estimates.

Table 2

States Ranked by Deductible Taxes Per Capita - 1982

State	Deductible Taxes Per Capita	Deductible Taxes as Percent of Income	Rank	Income Per Capita	Rank	Percent of Returns Itemizing	Rank
District of Columbia	$ 1,583	10.7	3	$ 14,743	1	34.2%	20
New York	1,422	11.7	1	12,204	10	43.9	4
Wyoming	1,375	11.3	2	12,222	9	31.4	31
Hawaii	1,122	9.7	4	11,590	16	34.4	17
Massachusetts	1,066	8.7	9	12,287	6	34.1	22
California	1,018	8.1	16	12,617	5	37.2	10
Michigan	1,000	9.3	5	10,751	27	40.9	7
Maryland	992	8.1	14	12,280	7	44.7	3
Wisconsin	987	9.2	7	10,774	26	36.8	11
New Jersey	948	7.2	26	13,164	4	35.1	15
Rhode Island	940	8.6	10	10,930	21	31.8	29
Minnesota	925	9.0	8	10,290	31	41.6	5
Alaska	925	5.5	45	16,854	2	30.2	33
Connecticut	917	6.6	35	13,939	3	33.8	24
Colorado	917	7.5	20	12,239	8	44.7	2
Illinois	899	7.5	21	12,027	11	33.8	25
Iowa	868	8.2	13	10,635	29	33.1	26
Oregon	845	8.3	12	10,148	32	39.7	9
Washington	827	7.1	27	11,694	15	36.1	12
Kansas	823	6.9	28	11,850	14	34.2	18
Arizona	812	8.1	15	10,053	34	39.8	8
Nebraska	799	7.3	22	10,886	24	35.4	14
Utah	797	9.2	6	8,693	47	45.0	1
Maine	785	8.5	11	9,264	41	17.9	50
Vermont	759	8.0	18	9,518	38	34.2	19
Montana	750	7.8	19	9,617	37	21.6	47
Pennsylvania	745	6.8	30	10,928	23	28.0	39
Indiana	734	7.3	23	10,019	35	28.5	37
West Virginia	718	8.0	17	8,966	46	17.7	51
Virginia	718	6.3	36	11,353	18	34.1	21
Ohio	718	6.7	33	10,659	28	28.5	38
Georgia	697	7.2	25	9,637	36	29.8	34
South Dakota	679	7.3	24	9,332	39	17.9	49
Delaware	676	5.7	44	11,912	13	41.2	6
Nevada	638	5.4	47	11,919	12	35.1	16
Missouri	638	6.1	38	10,403	30	32.7	27
Oklahoma	634	5.7	42	11,071	20	35.9	13
Texas	612	5.4	46	11,380	17	26.1	42
North Carolina	610	6.7	34	9,147	42	27.7	40
Idaho	609	6.8	32	9,012	45	32.1	28
South Carolina	598	6.9	29	8,613	49	31.0	32
Louisiana	581	5.8	41	10,065	33	24.7	43
New Mexico	576	6.2	37	9,285	40	29.7	35
Florida	571	5.2	49	10,929	22	26.8	41
North Dakota	570	5.2	48	10,866	25	23.5	45
New Hampshire	569	5.1	50	11,131	19	21.4	48
Kentucky	555	6.1	39	9,122	43	33.8	23
Mississippi	525	6.8	31	7,733	51	23.8	44
Tennessee	516	5.7	43	9,029	44	21.6	46
Arkansas	496	5.9	40	8,444	50	28.9	36
Alabama	443	5.1	51	8,684	48	31.8	30
Total	$ 835	7.5%	—	$ 11,113	—	33.4%	—

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1/ These represent 94% of the deductions for taxes paid in 1982.

Source: Treasury estimates and Advisory Commission on Intergovernmental Relations.

Table 3

Use of Different Deductible Taxes by States in 1982

Percent of Taxes that can be Itemized 1/

State	Property Taxes	General Sales Taxes	Individual Income Taxes
Alabama	19.8%	50.7%	29.5%
Alaska	89.1	10.9	0
Arizona	38.7	42.4	18.9
Arkansas	31.6	37.4	31.0
California	33.1	37.3	29.6
Colorado	43.0	37.3	19.7
Connecticut	60.6	34.7	4.7
D.C.	34.0	24.8	41.2
Delaware	26.8	0	73.2
Florida	53.1	46.9	0
Georgia	35.3	34.6	30.1
Hawaii	22.8	51.8	25.5
Idaho	37.9	24.7	37.4
Illinois	47.2	31.1	21.7
Indiana	42.7	37.9	19.5
Iowa	50.5	20.8	28.7
Kansas	51.0	25.7	23.2
Kentucky	27.0	33.5	39.5
Louisiana	22.4	68.9	8.7
Maine	48.6	27.9	23.5
Maryland	33.9	18.9	47.2
Massachusetts	47.4	14.8	37.8
Michigan	53.1	20.2	26.7
Minnesota	36.5	23.0	40.5
Mississippi	30.5	57.1	12.4
Missouri	35.7	36.2	28.1
Montana	76.1	0	23.9
Nebraska	55.6	26.5	17.8
Nevada	33.0	67.0	0
New Hampshire	97.3	0	2.7
New Jersey	61.8	19.7	18.6
New Mexico	25.4	72.8	1.7
New York	40.2	23.3	36.5
North Carolina	33.0	27.4	39.6
North Dakota	52.2	38.5	9.3
Ohio	45.7	26.0	28.3
Oklahoma	26.2	42.0	31.8
Oregon	56.8	0	43.2
Pennsylvania	39.0	25.1	35.9
Rhode Island	54.0	22.1	23.9
South Carolina	32.6	33.8	33.6
South Dakota	56.8	32.2	0
Tennessee	37.2	60.8	1.9
Texas	55.7	44.3	0
Utah	33.5	39.2	27.3
Vermont	59.0	12.2	28.7
Virginia	40.6	22.7	36.7
Washington	40.8	59.2	0
West Virginia	22.2	55.8	22.0
Wisconsin	43.9	20.4	35.7
Wyoming	60.4	39.6	0
U.S. Average	42.5%	31.4%	26.2%

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1/ Certain other taxes can also be itemized deductions. These three major taxes accounted for 94 percent of total taxes itemized in 1982.

Source: Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1982-83 Edition, Table 28.

IMPOSE FLOOR ON CHARITABLE DEDUCTIONS

General Explanation

Chapter 3.18

Current Law

Individuals and corporations are allowed a deduction for contributions to or for the benefit of religious, charitable, educational, and similar nonprofit organizations. Current law limits the allowable deduction to a specified percentage of the donor's income but does not set a threshold below which contributions may not be deducted.

Reasons for Change

It is extremely difficult for the Internal Revenue Service to monitor deductions claimed for countless small donations to eligible charities. The expense of verification is out of proportion to the amounts involved. Dishonest taxpayers are thus encouraged to believe that they can misrepresent their charitable contributions without risk.

Most individuals would contribute small amounts to charitable organizations without the incentive of an income tax deduction. Thus, the efficiency of the Federal subsidy to charitable organizations is very low with respect to small donations.

Proposal

Individuals and corporations would be allowed charitable contribution deductions only to the extent such contributions exceed two percent of the taxpayer's adjusted gross income (AGI).

Effective Date

The proposal would be effective for contributions made in taxable years beginning on or after January 1, 1986. For contributions made in taxable years beginning after December 31, 1985, and before January 1, 1987, however, a one percent floor would apply in place of the two percent floor.

Analysis

Two percent of AGI is approximately the median charitable contribution deduction claimed by taxpayers who itemize deductions. In other words, one-half of all itemizers claim less than one percent of their AGI, while one-half claim more than that, as charitable contribution deductions. Thus, the proposal would disallow all of the charitable deductions of about one-half of all taxpayers who itemize.

Table 1 shows the distribution of charitable contributions by families. The first two columns (labeled Total Donors) refer to all contributions, whether itemized as deductions on tax returns or not. Of the 68 million families making donations, about 40 percent claim an itemized deduction for charitable contributions under current law, as shown in the next two columns, ranging from three percent in the lowest income class to 90 percent in the highest. Although itemizers account for only 40 percent of all donating families, they give almost 70 percent of total contributions.

By removing tax deductions for small charitable gifts, the proposal would simplify recordkeeping requirements for taxpayers and would eliminate the need for the Internal Revenue Service to spend resources verifying these small contributions.

The proposal would have some effect on charitable giving, but the impact is not expected to be significant. It is doubtful that the first dollars of giving, or the giving of those who give only modest amounts, are affected significantly by tax considerations. Rather, contributions also depend on factors such as financial ability to give, membership in charitable or philanthropic organizations and general donative desire. As potential giving becomes large relative to income, however, taxes are more likely to affect the actual level of donations. Under the proposal, the current incentive would be maintained for the most tax sensitive group -- taxpayers who give above-average amounts.

Table 1

Distribution of Total and Deductible
Charitable Contributions by Economic Income -- 1983 1/

Family Economic Income	Total Donors (Includes non-filers): Families (thousands)	Total Donors (Includes non-filers): All Contributions (millions)	Itemized Deductions -- Present Law 2/: Families (thousands)	Itemized Deductions -- Present Law 2/: Deductions (millions)
$ 0 - 9,999	5,349	$ 1,398	164	$ 190
10,000 - 14,999	7,891	2,054	380	264
15,000 - 19,999	8,159	2,394	743	415
20,000 - 29,999	12,814	5,230	3,075	1,902
30,000 - 49,999	17,892	10,108	9,603	6,757
50,000 - 99,999	12,992	13,164	10,633	11,116
100,000 - 199,999	1,819	4,715	1,729	4,484
200,000 or more	424	6,628	411	6,593
Total	67,340	$ 45,691	26,738	$31,721

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1/ Source: Treasury estimates.
2/ Includes itemized returns only.

LIMIT CHARITABLE DEDUCTION FOR APPRECIATED PROPERTY

General Explanation

Chapter 3.19

Current Law

A taxpayer who makes a gift of appreciated property to charity generally does not realize income with respect to any appreciation in the property's value. (In the case of a sale of appreciated property to charity for less than its fair market value, the transaction is treated as in part a gift and in part a sale, and the taxpayer realizes income with respect to an allocable portion of the property's appreciation.) A taxpayer also does not realize a loss for tax purposes on a charitable donation of depreciated property. Any deductible loss with respect to such property will be realized, however, if the taxpayer sells the property and donates the proceeds to charity.

In general, current law allows a charitable contribution deduction for the fair market value of appreciated (or depreciated) property donated to charity. This general rule is subject to exceptions depending on the identity of the donee, the donee's use of the property and the character and holding period of the property in the hands of the donor. In the case of long-term capital gain property, if the donee's use of the property is unrelated to its exempt purpose or if the donation is to certain types of private foundations, the amount of the deduction is reduced by 40 percent (about 57 percent for a corporate donor) of the donor's unrealized long-term capital gain. Thus, a deduction is allowed for the entire adjusted basis of the property plus 60 percent of the appreciation (about 43 percent for a corporate donor). In the case of other appreciated property, the allowable deduction is reduced by the amount of ordinary income or short-term capital gain that the donor would have realized if the property had been sold for its fair market value.

Donors of most property with a value of more than $5,000 must obtain an appraisal of the property from a qualified appraiser and must attach a summary of the appraisal to the tax return on which the deduction is claimed in order to obtain a deduction. Contributions of other property must be substantiated under regulations.

Reasons for Change

The current treatment of certain charitable gifts of appreciated property is unduly generous and in conflict with basic principles governing the measurement of income for tax purposes. In other circumstances where appreciated property is used to pay a deductible expense, or where such property is the subject of a deductible loss, the deduction allowed may not exceed the taxpayer's adjusted basis plus any gain recognized. Thus, a taxpayer generally may not receive a tax deduction with respect to untaxed appreciation in property. The current tax treatment of certain charitable gifts departs from this principle by permitting the donor a deduction for the full value of the property, including the element of appreciation with respect to which the donor does not realize gain.

The generous tax treatment for certain gifts of appreciated property also creates an incentive for taxpayers to make gifts of such property rather than gifts of cash, even though in many instances charities would prefer to receive cash rather than property of equivalent value. A taxpayer in the 40 percent bracket making a gift of $200 in cash receives a $200 deduction. This translates to an $80 savings in tax, which reduces the after-tax cost of the $200 gift to $120. The same taxpayer donating $200 worth of property that is a capital asset held for the long-term capital gain holding period receives the same $200 deduction and $80 in tax savings. If, however, the donated property is appreciated property, the donor receives an additional tax savings by avoiding tax on the property's appreciation. Although the value of this tax savings depends on the amount of the property's appreciation and on when and how the donor otherwise would have disposed of the asset, its availability has proved to have a significant influence on the form of charitable donations.

Current law does limit the amount of the deduction for certain gifts of appreciated property, but these rules are only a partial response to the problem and require complicated inquiries concerning the donee's use of the property and the character of the property in the donor's hands. In addition, under current law it is necessary in almost all instances to value the donated property. This is a significant burden for taxpayers and for the Internal Revenue Service and leaves the system open to serious abuse through fraudulent overvaluations of contributed property.

Proposal

A deduction for charitable donations of property would be allowed for the lesser of the fair market value or the inflation-adjusted basis of the property. See Chapter 9.01 for a discussion of the indexation of capital assets. (In the case of a part sale/part gift, the amount of the charitable contribution deduction would be the portion of the inflation-adjusted basis of the property attributable to the gift portion of the transaction). As under current law, gain or loss would not be realized on charitable gifts.

Effective Date

The proposal would be effective for contributions made in taxable years beginning on or after January 1, 1986.

Analysis

For most income groups, charitable contributions are usually made in the form of cash, rather than property. For returns with adjusted gross incomes under $100,000, less than ten percent of contributions constitute property. Only for incomes over $200,000 does property account for as much as 40 percent of all contributions. Thus, the benefits of present law accrue to taxpayers with the highest marginal tax rates.

The proposal would eliminate the unwarranted tax advantages for donations of appreciated long-term capital gain property, as well as the complex rules limiting deductions for the various types of property that may be given to charity. In addition, the proposal would substantially eliminate the most serious opportunities for abuse through overvaluations of donated property.

The proposal also would eliminate the need for detailed valuations of contributed property in those cases in which the fair market value of the property clearly exceeds its adjusted basis. A determination of fair market value would still be needed for a part sale/part gift of appreciated property. Although valuations also would continue to be necessary for many gifts of depreciated property, taxpayers could ordinarily be expected, as under current law, to sell certain types of depreciated property and donate the proceeds of the sale in order to receive the benefit of any deductible loss. By significantly reducing the instances in which property valuations would be necessary, the proposal would ease the burden on taxpayers and the Internal Revenue Service caused by appraisal requirements.

The elimination of the current overly generous treatment of gifts of appreciated long-term capital gain property may have some adverse impact on the level of charitable giving. Some taxpayers, who are able to make gifts to charity at little or no after-tax cost under current law, may reduce their level of giving if current tax benefits are no longer available. The charitable contribution deduction, however, would still provide a significant incentive for charitable giving.

REVISE PERCENTAGE LIMITATION ON CHARITABLE CONTRIBUTION DEDUCTIONS

General Explanation

Chapter 3.20

Current Law

The deduction for charitable contributions is subject to a variety of limitations based on the amount of the donor's income, the identity of the charitable donee and the character of the donation. For individual donors the charitable contribution deduction in any taxable year generally is limited to (a) 50 percent of the taxpayer's contribution base (defined as adjusted gross income before net operating loss carrybacks) for contributions to -- but not those for the use of -- certain organizations (generally public charities and private operating foundations), often referred to as "50 percent charities," or (b) the lesser of (i) the amount described in (a) that is unused and (ii) 20 percent of the taxpayer's contribution base for other charitable contributions (those for the use of 50 percent charities and those to or for the benefit of charities other than 50 percent charities). If, however, an individual contributes an appreciated capital asset that has been held for the long-term capital gain holding period, the deduction with respect to that property generally is limited (subject to the additional 50 percent and 20 percent limits) to 30 percent of the taxpayer's contribution base. This 30 percent limitation does not apply if the taxpayer elects to deduct only the adjusted basis, rather than the fair market value, of such property.

If an individual's contributions exceed the 50 percent limit or the 30 percent limit in any year, the excess ordinarily may be carried forward for five years. Excess contributions for the use of (but not to) 50 percent charities may not be carried forward. Excess contributions to 20 percent charities also may not be carried forward.

For corporations, the charitable contribution deduction is limited to ten percent of the corporation's taxable income, computed without regard to net operating or capital loss carrybacks. Amounts in excess of the ten percent limit may be carried forward for five years. Corporate contributions are deductible only if the gift is to be used within the United States.

Reasons for Change

The percentage limitations on charitable contribution deductions were imposed by the Tax Reform Act of 1969. At that time the after-tax cost of a charitable contribution could be extremely small for high income donors because of high marginal tax rates and because a deduction was allowed for the element of untaxed appreciation in certain types of donated property. The limitations on charitable contributions were adopted in order to prevent wealthy donors from taking advantage of the favorable tax treatment of charitable donations substantially to eliminate their tax liabilities.

Since 1969, the top marginal tax rate has been reduced from 70 percent to 50 percent and would be further reduced to 35 percent under the Treasury Department proposals. In addition, the Treasury Department proposals would deny a charitable contribution deduction for the element of untaxed appreciation in donated property. Since those changes would increase the after-tax cost of charitable contributions, there would be no continuing need to limit the amounts of contributions for which donors receive deductions. Although a generous donor might still be able substantially to eliminate a particular year's tax liability through a large donation, the contribution would involve a proportionately large out-of-pocket cost to the donor.

Repeal of the percentage limitations for individual donors would also greatly simplify the tax treatment of charitable gifts. In addition, repeal would substantially eliminate the difficult questions arising under current law when an individual dedicates all or a substantial portion of his or her earnings to a charitable organization. Since income is generally taxed to the person who earns it, even if it is given away before it is earned, the percentage limitations may result in a tax liability for the individual on earnings dedicated to charity. This is a harsh result in a number of cases, such as where a member of a religious order donates his or her entire income to charity under a vow of poverty.

Proposal

The percentage limitations on gifts to or for the use of 50 percent charities would be repealed, together with the related carryover rules. (Carryovers from years prior to the effective date of the proposal would be allowed, subject to the percentage limitations under current law.) The current 20 percent limit on gifts by individuals to or for the use of charities other than 50 percent charities would be retained. In addition, contributions by corporations to or for the use of charitable organizations other than 50 percent charities would be limited to five percent of the corporation's taxable income, computed without regard to net operating or capital loss carrybacks. This five percent limit on gifts by corporations also would apply to contributions to any charitable organization that owns, directly or indirectly, more than one percent of the value or voting power of the donor corporation, or that is owned or controlled by persons who own or control the donor corporation. This limit is necessary to maintain the integrity of the feeder organization rules, which generally provide that a corporation shall not be exempt from tax merely because it pays all of its profits to a tax-exempt organization. (Section 502.) No carryovers of contributions in excess of these limits would be allowed. A provision that in effect provides relief from the percentage limitation in the case of certain corporate contributions to the American Red Cross would be repealed as superfluous. (Section 114.)

Effective Date

The proposal would be effective for charitable contributions made in taxable years beginning on or after January 1, 1986.

Analysis

Although difficult to estimate precisely, it appears that fewer than 50,000 taxpayers (out of 100 million) would be affected by the proposal. Over one-half of the estimated revenue loss that would result from the proposal would be attributable to returns with AGI in excess of $200,000.

REPEAL CHARITABLE CONTRIBUTION DEDUCTION FOR NONITEMIZERS

General Explanation

Chapter 3.21

Current Law

Contributions and gifts to or for the use of certain charitable and similar organizations are deductible, subject to certain limitations. Prior to 1981, a charitable contribution could be deducted only by individuals who itemized their deductions. The Economic Recovery Tax Act of 1981 (ERTA) extended the charitable contribution deduction to nonitemizing taxpayers, phased in over a five-year period. For contributions made in the 1984 tax year, individuals who do not itemize deductions are permitted to deduct 25 percent of the first $300 of contributions made. For 1985 and 1986, the $300 limitation is removed and the percentage of contributions deductible by nonitemizers is increased to 50 percent and 100 percent, respectively. Thus, under current law, the charitable contribution deduction will be allowed in full to nonitemizers in 1986. This provision, however, is scheduled to expire after 1986. After that time the charitable contribution deduction again will be limited to individuals who itemize their deductions.

Reasons for Change

Taxpayers are not subject to tax on their income up to the zero bracket amount (ZBA). This exemption is generally regarded as an allowance for certain personal expenses which ought not to be included in income and which all taxpayers are deemed to incur. In lieu of the ZBA, a taxpayer may itemize deductible personal expenses, such as certain medical expenses, interest expenses, and, prior to the ERTA changes, charitable contributions. Allowing a deduction for charitable contributions by nonitemizers in effect creates a double deduction for such contributions -- first through the ZBA, which is available only to nonitemizers, and second through the charitable deduction.

The allowance of a charitable contribution deduction for nonitemizers adds complexity to the tax law. These taxpayers must retain records of their gifts and go through additional computational steps in calculating their tax liability.

The charitable contribution deduction also creates serious enforcement problems. Nonitemizers generally make smaller charitable gifts than itemizers. A deduction may be claimed for numerous small gifts, made to a number of different organizations. It is extremely difficult and expensive for the Internal Revenue Service to monitor these deductions. Further, the cost of administration is disproportionate to the amounts involved. These factors may prompt dishonest taxpayers to conclude that they can misrepresent their charitable gifts with impunity.

The charitable contribution deduction was extended to nonitemizers in order to stimulate charitable giving by such individuals. There is little data, however, indicating that the provision has had any significant effect on charitable giving by such individuals.

Proposal

The charitable contribution deduction for nonitemizers would be repealed.

Effective Date

The proposal would be effective for contributions made in taxable years beginning on or after January 1, 1986.

Analysis

In 1982, 19 million returns, representing 31 percent of all nonitemizers, claimed $431 million in charitable deductions. For 1983, preliminary statistics indicate that 23 million returns, 40 percent of all nonitemizers, claimed $500 million in charitable deductions.

Although repeal of the charitable contribution deduction for nonitemizers may have some effect on charitable giving, any adverse impact is not expected to be significant. Nonitemizers generally have lower incomes and, thus, have lower marginal tax rates than itemizers. For this reason, tax incentives have less influence on nonitemizers. Moreover, since the deduction under current law is scheduled to expire in 1987, the proposal would have no impact on tax liabilities in years subsequent to 1987.

The proposal would simplify both the regular tax form (1040) and the short-form (1040A). The current deduction requires that a "worksheet" be included in the tax form instructions, on which the taxpayer makes calculations, the results of which are subsequently transferred onto Form 1040 or 1040A.

Part E. Tax Abuses--Mixed Business/Personal Use

Many expenses that involve significant personal consumption are currently being deducted as business expenses. This is unfair to taxpayers who do not have access to business perquisites and also distorts consumption choices. The proposals would limit deductions for entertainment, business meals, and travel expenses. In addition, rules are proposed to specify the circumstances under which taxpayers who have no regular place of work can deduct commuting expenses.

LIMIT DEDUCTION FOR ENTERTAINMENT AND BUSINESS MEAL EXPENSES

General Explanation

Chapter 3.22

Current Law

Ordinary and necessary expenses paid or incurred during a taxable year generally are deductible if the expenses bear a reasonable and proximate relation to the taxpayer's trade or business or to activities engaged in for profit. Although ordinary and necessary business expenses may include entertainment expenses, the deductibility of business entertainment expenses is subject to a number of separate and additional requirements.

Business meals are deductible if they occur under circumstances that are "conducive to a business discussion." There is no requirement that business actually be discussed, either before, during, or after the meal. Expenses for other entertainment activities are deductible only if they are "directly related to" or "associated with" the taxpayer's trade or business. Entertainment activities are considered "directly related" if the taxpayer has more than a general expectation of deriving income or a specific trade or business benefit (other than goodwill) from the activity. The taxpayer need not show that income actually resulted from the entertainment. In general, entertainment expenses satisfy the "associated with" standard if they are directly preceded or followed by a substantial and bona fide business discussion. A business discussion may be considered substantial and bona fide even if it consumes less time than the associated entertainment and does not occur on the same day as the entertainment activity.

Entertainment facilities, such as yachts, hunting lodges, or country clubs, used to entertain clients or customers are also subject to separate rules. A deduction is allowed for the portion of the cost of club memberships that are "directly related" to the taxpayer's business if the facilities are used primarily for business purposes. No deduction is allowed for other types of entertainment facilities. Tickets to sporting and theatrical events, and the costs of skyboxes, lounges, boxes or other similar arrangements that provide the taxpayer a specific viewing area to a sporting or theatrical event are not, however, considered to be expenses related to an entertainment facility. Thus, such expenses are fully deductible if they meet the "directly related to" or "associated with" tests for entertainment activities.

Entertainment expenses also are subject to separate substantiation requirements. Deductions for entertainment expenses must be supported by records showing the amount of the expense, time and place of entertainment, business purpose of the expense, and business relationship to the taxpayer of any persons entertained.

Reasons for Change

In General. The special requirements for deductibility of business entertainment expenses have been the subject of repeated Congressional concern since their enactment in 1962. The existing requirements are an attempt to provide taxpayers and the Internal Revenue Service with standards for deductibility. Current standards, however, are predominantly subjective, leaving application of the law uncertain and creating significant opportunities for abuse. Under present law, the costs of country club memberships, football and theater tickets, parties, and lunches and dinners at expensive restaurants are all deductible, if a plausible business connection can be demonstrated. The existing tests for whether a business connection exists are premised upon the taxpayer's expectations and intentions, and thus may result in a deduction being allowed in cases where less time was devoted to business than to entertainment, no business was discussed, or the taxpayer was not even present at the entertainment activity.

The liberality of the law in this area is in sharp contrast to the treatment of other kinds of expenses that provide both business and personal benefits. In some cases, such as work-related clothing, the presence of any personal benefit is deemed sufficient reason to disallow any deduction. In other cases, taxpayers are allowed to deduct only the proportion of expenses allocated to business. In contrast, present law often allows full deductibility of certain entertainment expenses even though the connection between the entertainment expense and business activity is extremely tenuous.

Efficiency. The treatment of "business related" entertainment under current law encourages excessive spending on entertainment. The business person in a 40 percent marginal tax bracket considering whether to order a $20 or a $30 "business meal" knows that the more expensive dinner, though its price is $10 higher, will only cost $6 more because of the available deduction. The taxpayer's choice of meals is much more likely to be based on personal rather than business considerations, but the deductibility of the expense makes selection of the expensive meal more likely than in a nonbusiness context. Similarly, a business person in the 50 percent marginal tax bracket may conclude that it costs nothing extra to take a business associate to the theater even if it serves little or no business purpose. The attendance of the business associate permits a claim that the cost of both tickets are deductible, and thus an extra ticket costs nothing on an after-tax basis.

Present law has no effective response to these practices because it attempts to separate personal from business entertainment expenses on the basis of the taxpayer's intentions and purposes. It is frequently possible to demonstrate an actual business purpose or connection for an entertainment expense that nevertheless has a strong, if not predominant, element of personal consumption. The problem is exacerbated by the fact that no objective standards exist for determining whether an expense is based upon the personal or business benefits derived. The use of the subjective terms "directly related" and "associated with" leads to liberal interpretations by taxpayers, who cannot reasonably be expected to deny themselves the benefit of any doubt. Moreover, as an administrative matter, entertainment expense deductions are often difficult to audit. The cost of giving a party for friends who are also business associates is often allowed even if the primary motive for the party was personal enjoyment, not business benefit.

Fairness. The current treatment of business entertainment expenses encourages taxpayers to indulge personal entertainment desires while at work or in the company of business associates. The majority of taxpayers, however, do not benefit from this incentive. Most hold jobs that do not permit business entertainment, and many others are scrupulous in claiming business deductions for personal entertainment.

Current law thus creates a preference for the limited class of taxpayers willing and able to satisfy personal entertainment desires in a setting with at least some business trappings. Lunches are deductible for a business person who eats with clients at an elegant restaurant, but not for a plumber who eats with other workers at the construction site. A party for friends of a business person is deductible if they are business associates, but a party for friends of a secretary, sales clerk, or nurse is not deductible.

Extreme abuses of these deductions are frequently cited by those who assail the tax system as unfair. Abuses, even if rare, seriously undermine the integrity of the tax system and undercut the public trust that is essential to it. Some limitation on the deductibility of entertainment expenses is necessary if such perceptions of unfairness are to be eliminated.

Proposal

No deduction would be allowed for entertainment expenses, except for certain business meals. A deduction would be allowed for ordinary and necessary business meals furnished in a clear business setting (as defined in Treasury regulations). For each person participating in each business meal, this deduction would be limited to \$10 for breakfast, \$15 for lunch, and \$25 for dinner. The meal cost limitations would include gratuities and tax with respect to the meal.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986, except that a deduction would be allowed for 50 percent of ordinary and necessary business meals expense (in excess of meal limit) incurred in taxable years beginning on or before January 1, 1987.

Analysis

Business Meal Limitations. Business meals provide a mixture of business and personal benefits. The extent to which a meal provides a personal benefit will vary, and it is not possible to develop rules that would specify the precise percentage of personal benefit in specific cases. The proposal, therefore, provides objective limitations that are intentionally quite generous, yet are intended to deny deductions for that portion of meal costs which is most likely to constitute personal rather than business benefit. Expenses in excess of the limitation are deemed to be incurred for personal rather than business reasons. The deduction will be disallowed only for the amount above the stated limit.

Representatives of the restaurant industry in testimony before Congress have provided several estimates of the average cost of restaurant meals. If adjusted for inflation, those estimates would range between $6.50 and $10.00 for 1983. In addition, Census data shows that only about 2.5 percent of all restaurant meals in 1977 were in restaurants where the average bill exceeded $10.00. Adjusted for inflation, this suggests that only about 2.5 percent of all meals were in restaurants with average bills over $17.00 in 1983.

While the proposal will reduce the number of expensive business meals, it is expected that the limitations will not have a significant impact on more than five percent of restaurants. Moreover, since some high-cost meals will be replaced by moderate-cost meals, the effect on total employment in the restaurant industry is expected to be modest.

Businesses are currently required to keep detailed records for all deductible meals. Therefore, the additional recordkeeping costs should be minimal.

Placing ceilings on the deductibility of business meals would eliminate the extreme cases of abuse -- those that affect the average taxpayer the most. Despite its small revenue effect, the proposal would be of significant assistance in restoring trust in the tax system.

The Elimination of Other Entertainment Deductions. The proposal would completely eliminate deductions for entertainment expenses such as tickets to professional sporting events, tickets to the theater, the costs of fishing trips, and country club dues. Because all such entertainment has a large personal component, the proper tax treatment, on both efficiency and equity grounds, is to disallow a deduction.

Approximately one-third of all baseball tickets and over one-half of all hockey tickets are purchased by businesses. The net effect is often to raise the cost of tickets for those who are not subsidized through the tax system for their purchases. Some performing arts organizations also sell large proportions of their tickets to businesses. Some tickets bought by businesses would remain deductible as gifts to their employees, but only if individual gifts are valued at less than $25.

If a public subsidy of such entertainment is desirable, a direct expenditure program could better target the aid. Further, current law raises serious equity questions by increasing the demand for tickets thereby causing the price of tickets to rise for the general public.

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LIMIT DEDUCTION FOR TRAVEL EXPENSES

General Explanation

Chapter 3.23

Current Law

Travel expenses incurred by a taxpayer while "away from home" are deductible if such expenses are reasonable and necessary in the taxpayer's business and are directly attributable to the taxpayer's business. Travel expenses may include the cost of travel to and from the destination and the cost of meals, lodging, and other incidental travel costs (e.g., laundry, taxi fares) incurred while at the business destination. A taxpayer's "home" for purposes of the deduction is generally his or her business headquarters. A taxpayer is considered to be "away" from his or her business headquarters only if the travel involves a "temporary" rather than an "indefinite" assignment at another location. If a taxpayer accepts a job at a distant location for an indefinite period, the new job location becomes the taxpayer's tax home. Temporary employment generally is expected to last for a short or foreseeable period of time, but whether employment is temporary or indefinite is essentially a factual question.

The cost of commuting to and from a taxpayer's business headquarters is not considered business travel. Commuting costs generally are considered to relate to an individual's personal choice of his or her place of residence rather than to business necessity and are not deductible. An exception to the commuting rule has sometimes been made for taxpayers, such as construction workers, who are employed on a temporary basis at one or more job sites beyond the metropolitan area where they reside.

The costs of attending a convention or other meeting (including the costs of meals and lodging) in the North American area are deductible if the taxpayer is able to show that attendance at the convention is directly related to his or her trade or business and that such attendance is advancing the interests of the taxpayer's trade or business. The North American area includes the United States, the U.S. possessions, the Trust Territory of the Pacific Islands, Canada, Mexico, and certain Caribbean countries that have entered into exchange of tax information agreements with the United States. A stricter rule applies for conventions held outside the North American area. In order to claim a deduction for the costs of attending such a convention, a taxpayer must also show that it was "as reasonable" for the meeting to be held outside the North American area as within it.

Deductions for conventions, seminars, or other meetings held on cruise ships are subject to additional limitations. No deduction is allowed unless the cruise ship is registered in the United States and only at ports of call in the United States or in possessions of the United States. In any event, a taxpayer may deduct no more than $2,000 for such meetings per year.

Professional education expenses, including travel as a form of education, are deductible if the education maintains or improves existing employment skills or is required by an employer, or applicable law or regulation. To be deductible, the travel must be directly related to the duties of the taxpayer in his or her employment or other trade or business. The deductible educational travel may occur while the taxpayer is on sabbatical leave.

Reasons for Change

The present limitations on deductions for business travel fail to establish reasonable distinctions between costs incurred for business purposes and costs reflecting personal consumption. The deduction for expenses for meals and lodging incurred "away from home" is premised on the assumption that the business traveler incurs additional costs while away from home. Restaurant meals are likely to be more expensive than the cost to the taxpayer of eating at home, and hotel accomodations are a duplicative expense for the taxpayer who maintains regular living quarters elsewhere. These excess costs incurred by a taxpayer away from home are, at least in part, legitimate business expenses.

Current law, however, does not limit the deduction for away from home meals and lodging to the portion of the cost that represents an extra or duplicate expense. The full deductiblility of such travel expenses permits a taxpayer who is away from home to deduct some costs that would be incurred even if he had stayed at home. For example, a taxpayer may deduct the full cost of meals even though some costs for meals would have been incurred if the taxpayer were not away from home. Moreover, the full deductibility of business travel expenses encourages excessive spending. For example, an additional $30 for more expensive accomodations will cost a business traveler only $18 if he or she is in the 40 percent marginal tax bracket and, as is likely under current standards, can establish that such accomodations are an ordinary and necessary expense.

The liberality of current law is greatest for taxpayers who remain away from home in a single city for an extended period of time. Extended travel status permits the taxpayer to take advantage of certain economies not available on shorter trips. For example, a professor visiting another university for a year probably will spend the same amount for lunch or dinner as he or she would have spent at home. Similarly, a taxpayer on extended travel at a single location ordinarily will be able to reduce the incidental costs of travel, such as laundry or transportation to the office.

In addition, the current tax treatment of trips that combine business travel with a vacation create opportunities for abuse. Many travel and business publications feature articles and promotional material that explain how taxpayers can pay for vacations with tax deductible dollars. These abuses distort business decisions and reduce the efficiency of the economy. For example, a taxpayer may alter the place and timing of business meetings for no reason other than to coincide with vacation plans. The current rules are also unfair. Some individuals are able to take deductions for personal expenses simply because they are better informed about the law. The presence of such obvious abuses undercut taxpayer trust in the integrity of the tax system.

The current deduction for travel as a form of education creates an even greater opportunity for abuse. Availability of the deduction is premised solely on the taxpayer's intent and expectation in making the trip. Accurate administrative review of such expenses is impossible due to the lack of objective standards.

Proposals

1. Deductions for meals, lodging, and incidental travel expenses incurred by a taxpayer while located in one city away from home for 30 days or less would be limited to 200 percent of the maximum Federal reimbursement rate per day for that city, as published in the Federal Property Management Regulations, 101-7, G.S.A. Bulletin F.P.M.R. A-40. For example, the current applicable limit for a taxpayer located in Baltimore, Maryland for 30 days or less would be $150 per day. Deductions for expenses for meals and lodging incurred by a taxpayer while located in one city away from home for more than 30 days would be limited to 150 percent of the Federal per diem rate for that city. No deduction would be allowed for incidental travel expenses (e.g., lanudry, taxi fares) incurred by a taxpayer while located in one city away from home for more than 30 days. For purposes of determining whether a taxpayer is away from home, travel assignments which extend for more than one year in one city would be considered indefinite, and travel deductions be allowed.

2. A deduction for the daily transportation expenses of taxpayers (such as construction workers) who have no regular place of work and must travel at least 35 miles (one way) to job assignments that last less than one year would be allowed for the commuting expenses incurred for mileage in excess of 35 miles (one way).

3. For purposes of determining whether a taxpayer is away from home, travel assignments which extend for more than one year in one city would be considered indefinite, and no travel deductions would be allowed.

4. Employee business travel expenses that are not reimbursed by a taxpayer's employer under a reimbursement or other expense allowance arrangement would be deductible to the extent such expenses, together with miscellaneous itemized deductions, exceed one percent of the employee's adjusted gross income. For a discussion of the one percent floor on the deductibility of the such expenses, see Chapter 4.03.

5. No deduction would be allowed for business travel by ocean liner, cruise ship, or other form of luxury water transportation in excess of the cost of otherwise available business transportation unless the taxpayer provides proof of existing medical reasons for utilizing such transportation.

6. No deduction would be allowed for conventions, seminars, or other meetings held aboard cruise ships.

7. No deduction would be allowed for travel as a form of education.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposed limitations on travel expense deductions are designed to provide reasonable boundaries and eliminate the most extreme cases of abuse without unduly restricting deductions for legitimate business expenses. The dollar limitations are intentionally quite generous and are intended to deny deductions for that portion of travel expenses that is most likely to constitute personal satisfaction rather than business convenience. Expenditures in excess of the applicable limitation are deemed to represent luxury accomodations and meal costs incurred for personal rather than business reasons. The lower limits for trips lasting longer than 30 days reflect the economies that are available during extended periods of travel; the disallowance of incidental expenses after 30 days in one city recognizes the significant personal component of such expenses.

The proposed treatment for taxpayers, such as construction workers, who have no regular place of work addresses an area of the law that is a continuing source of litigation and confusion. Although commuting expenses to and from a regular place of work are nondeductible without regard to the length of the commute, it is reasonable to permit a deduction for transportation expenses to a nonregular place of work, such as a construction site, where the taxpayer is employed for a temporary period. Commuting expenses generally are disallowed on the theory that where a taxpayer chooses to reside -- whether near or far from the workplace -- is a matter of personal choice. That rationale is inappropriate when a taxpayer's workplace is constantly shifting, the jobs are temporary in nature, and the taxpayer must travel long distances to reach the job site.

The special commuting deduction would be allowed only for transportation expenses in excess of 35 miles (one way), would not extend to meal costs, and would be available only for job assignments that last less than one year. By using an objective mileage standard rather than requiring that travel be outside the "metropolitan area," the proposal would eliminate uncertainty and create uniformity among taxpayers located in different parts of the country.

The one-year rule for defining temporary employment would eliminate a significant source of dispute between taxpayers and the Internal Revenue Service, and would provide a reasonable division between temporary and indefinite assignments. One year is sufficient time for regular living patterns to be established at the new location and, thus, food and lodging expenses would no longer need to be duplicative or more expensive than comparable costs at the original job site.

The disallowance of a deduction for the cost of travel by cruise ships, ocean liner, or other form of luxury water transportation in excess of the cost of otherwise available business transportation is intended to deny a deduction for the portion of the travel cost most likely to constitute personal rather than business benefit.

Part F. Tax Abuses--Income Shifting

Although the proposed rate schedule for individuals is flatter than under current law, there would remain a substantial difference between the top rate and bottom rate. Thus, as under current law, taxpayers subject to the top rate would have an incentive to shift income to their children or other family members subject to tax at lower rates. Current law limits income shifting through various rules, including the assignment-of-income doctrine and the interest-free loan provisions. This Part discusses proposed rules that would butress current limits on income-shifting by preventing taxpayers from reducing the tax on unearned income by transferring income to minor children or establishing trusts.

ADJUST TAX RATE OF UNEARNED INCOME OF MINOR CHILDREN

General Explanation

Chapter 3.24

Current Law

Minor children generally are subject to the same income tax rules as adults. If a child is claimed as a dependent on another taxpayer's return, however, the zero bracket amount is limited to the amount of the child's earned income. Accordingly, the child must pay tax on any unearned income in excess of the personal exemption ($1,040 in 1985).

Under current law, when parents or other persons transfer investment assets to a child, the income from such assets generally is taxed thereafter to the child, even if the transferor retains significant control over the assets. For example, under the Uniform Gifts to Minors Act (UGMA), a person may give stock, a security (such as a bond), a life insurance policy, an annuity contract, or money to a custodian for the child (who generally may be the donor). As a result of the gift, legal title to the property is vested indefeasibly in the child. During the child's minority, however, the custodian has the power to sell and reinvest the property; to pay over amounts for the support, maintenance, and benefit of the minor; or to accumulate income in the custodian's discretion.

Results similar to that achieved by a transfer under UGMA may be obtained by transferring property to a trust or to a court-appointed guardian. Parents also may shift income-producing assets to their children, without relinquishing control over the assets, by contributing such assets to a partnership or S corporation and giving the children partnership interests or shares of stock.

Reasons for Change

Under current law, a family may reduce its aggregate tax liability by splitting assets among family members. So-called income splitting is a common tax-planning technique. Parents frequently tranfser assets to their children so that a portion of the family income will be taxed at the child's lower marginal tax rate.

Income splitting undermines the progressive rate structure and is a source of unfairness in the tax system. It increases the relative tax burden of taxpayers who are unable to use this device, either because they do not have significant investment assets or do not have children.

The ability to shift investment income to children under current law is primarily of benefit to wealthy taxpayers. A family whose income consists largely of wages earned by one or both parents pays tax on that income at the marginal rate of the parents. Even though the income is used in part for the living expenses of the children, parents may not allocate a portion of their salary to their children and have it taxed at the children's lower tax rates. Moreover, parents with modest savings may not be able to afford to transfer such savings to their children; thus, such families must pay tax on the income from their savings at the parents' marginal tax rate. Families with larger amounts of capital, however, can afford to transfer some of it to the children, thereby shifting the income to lower tax brackets. Use of a trust or a gift under UGMA allows the parents to achieve this result without relinquishing control over the property until the children come of age.

Proposal

Unearned income of children under 14 years of age that is attributable to property received from their parents would be taxed at the marginal tax rate of their parents. This rule would apply only to the extent that the child's unearned income exceeded the personal exemption ($2,000 under the Treasury Department proposals). The child's tax liability on such unearned income would be equal to the additional tax that his or her parents would owe if such income were added to the parents' taxable income and reported on their return. If the parents reported a net loss on their return, the child's tax liability would be computed as if his or her parents' taxable income was zero. If more than one child has unearned income which is taxable at the parents' rate, such income would be aggregated and added to the parents' taxable income. Each child would then be liable for a proportionate part of the incremental tax.

All unearned income of a child would be treated as attributable to property received from a parent, unless the income was derived from a qualified segregated account. A child who receives money or property from someone other than a parent, such as another relative, or who earns income, could place such property or earnings into a qualified segregated account. No amount received directly or indirectly from a parent could be placed into such an account.

For purposes of this provision, an adopted child's parents would be the adoptive parent or parents. In the case of a foster child, the parents would be either the natural parents or the foster parents, at the child's election. If the parents are married and file a joint return, the child's tax would be computed with reference to the parents' joint income. If the parents live together as of the close of the taxable year, but do not file a joint return (i.e., file separate returns if married or file as single individuals), then the child's tax would be computed with reference to the income of the parent with the higher taxable income. If the parents do not file a joint return and are not living together as of the close of the taxable year, the child's tax would be computed with reference to the income of the parent having custody of the child for the greater portion of the taxable year.

Expenses that are properly attributable to the child's unearned income would be allowed as deductions against such income. Itemized deductions generally would be allocated between earned and unearned income in any manner chosen by the taxpayer. Interest expense, however, would be deductible against unearned income that is taxable at the parents' tax rate only if it was attributable to debt that was assumed by the child in connection with a transfer of property from the parents, or to debt that encumbered such property at the time of the transfer.

The personal exemption would be used first against income from a qualified segregated account and then against other unearned income. Thus, such income would not be taxable unless the child's total unearned income was greater than the personal exemption. Earned income and income from a qualified segregated account in excess of the personal exemption would be taxable (after subtracting the zero bracket amount or itemized deductions) under the rate schedule applicable to single individuals, starting at the lowest rate. (Unlike current law, the zero bracket amount could be used against both the child's earned income and unearned income from a segregated account.)

The proposed taxation of income of children under 14 years of age may be illustrated by the following example. Assume that a child had $3,000 of income from a qualified segregated account, other unearned income of $2,000, and earned income of $500. The personal exemption ($2,000) would be used against the qualified segregated account income, leaving $1,000 of such income plus $500 of earned income subject to tax at the child's rate. No tax on this $1,500 would be due, since it would be less than the zero bracket amount. The $2,000 unearned income would be subject to tax at the parents' rate. If the child had itemized deductions, they could be used against either this $2,000 or against the $1,500 taxable at the child's rate.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would help to ensure the integrity of the progressive tax rate structure, which is designed to impose tax burdens in accordance with each taxpayer's ability to pay. Families would be taxed at the rate applicable to the total earned and unearned income of the parents, including income from property that the parents transferred to the children's names. The current tax incentive for transferring investment property to minor children would be eliminated.

Under the proposal, the unearned income of a minor child under 14 years of age would be taxed at his or her parent's rate. This is the age at which children may work in certain employment under the Fair

Labor Standards Act. In addition, in most cases the income tax return of a child under 14 years of age is prepared by or on behalf of the parent and signed by the parent as guardian of the child. Thus, in most cases, the requirement that a child's income be aggregated with that of his or her parents would not create a problem of confidentiality with respect to the parents' return information, since there would be no need to divulge this information to the child.

Only children required to file a return under current law would be required to do so under the proposal. In 1981, only 612,000 persons who filed returns reporting unearned income were claimed as dependents on another taxpayer's return. This represents less than one percent of the number of children claimed as dependents in that year. Although the return would generally be filed by a parent on behalf of a child, liability for the tax would rest, as under current law, on the child.

REVISE GRANTOR AND NON-GRANTOR TRUST TAXATION

General Explanation

Chapter 3.25

Current Law

In General

The manner in which the income from property held in trust is taxed depends upon the extent to which the grantor has retained an interest in the trust. A so-called "grantor trust," a trust in which the grantor has retained a proscribed interest, is treated as owned by the grantor and the trust's income is taxable directly to the grantor. Non-grantor trusts, including "Clifford trusts," on the other hand, are treated as separate taxpayers for Federal income tax purposes, with trust income subject to a separate graduated rate structure.

The rules for determining whether a trust will be treated as a grantor trust are highly complex. In general, however, the test is whether the grantor has retained an interest in the trust's assets or income or is able to exercise certain administrative powers. For example, to the extent that the grantor (or a party whose interests are not adverse to the grantor) has the right to vest the trust's income or assets in the grantor, the trust will be treated as a grantor trust. Similarly, to the extent that the trust's assets or income may reasonably be expected to revert to the grantor within ten years of the trust's creation, the trust will generally be treated as a grantor trust.

In general, the income of a non-grantor trust is subject to one level of tax; it is taxable either to the trust itself or to the beneficiaries of the trust. Under this general model, trust income is included as gross income of the trust, but distributions of such income to trust beneficiaries are deductible by the trust and includible in the income of the beneficiaries.

The maximum distribution deduction permitted to a trust, and the maximum amount includible in the income of trust beneficiaries, is the trust's "distributable net income" (DNI). A trust's DNI consists of its taxable income computed with certain modifications, the most significant of which are the subtraction of most capital gain and the addition of any tax-exempt income earned by the trust.

To the extent that a trust distribution carries out DNI to a beneficiary, the trust essentially serves as a conduit, with the beneficiary taking into account separately his or her share of each trust item included in DNI. Under a complex set of rules, the computation of each beneficiary's share of an item of trust income generally depends upon the amount distributed to the beneficiary and the "tier" to which the beneficiary belongs. A distribution that does not carry out DNI -- such as one in satisfaction of a gift or bequest of specific property or a specific sum of money, or one in excess of DNI -- is not deductible by the trust and is not includible in the recipient's income. Similarly, because capital gains generally are excluded from the computation of DNI, a trust ordinarily is subject to taxation on the entire amount of its capital gain income even when it distributes an amount in excess of its DNI.

Adoption of Taxable Year

The trustee of a non-grantor trust may select a year ending on the last day of any month as the trust's taxable year. Although a trust distribution that carries out DNI is generally deductible by the trust in the taxable year during which it is made, the distribution is not taxable to the beneficiary until his or her taxable year with which or in which the trust's taxable year ends. Thus, for example, if an individual is a calendar-year taxpayer and is the beneficiary of a trust with a taxable year ending January 31, distributions made by the trust with respect to its year ending January 31, 1984, will not be subject to tax until the beneficiary's year ending December 31, 1984, even if they were made as early as February 1983.

Throwback Rules

The so-called "throwback rules" are applicable only to trusts that accumulate income rather than distribute it currently to the beneficiaries. These rules limit the use of a trust as a device to accumulate income at a marginal tax rate lower than that of the beneficiaries. DNI that is accumulated rather than distributed currently becomes undistributed net income (UNI) and may be subject to additional tax when distributed to the beneficiaries.

The rules for determining the amount, if any, of such additional tax are complex. In general, however, if a trust's current distributions exceed its DNI and the trust has UNI from prior taxable years, the excess distributions (to the extent of UNI) will be taxed at the beneficiary's average marginal tax rate over a specified period preceding the distribution as reduced by a credit for the tax paid by the trust on such UNI.

Reasons for Change

Taxpayer Fairness

The treatment of trusts as separate taxpayers with a separate graduated rate structure is inconsistent with a basic principle of the tax system that all income of an individual taxpayer should be subject to tax under the same progressive rate structure. The primary purposes of a trust are to manage investment assets and to allocate the income from those assets to beneficiaries. If trust income is to be taxed at a rate that is consistent with the purpose of the progressive rate structure, it should be taxed currently to those who have control over or receive the benefit of the trust's income. Where the grantor may reasonably be considered to have retained control or enjoyment of the trust, the trust's income is included appropriately in the grantor's income or taxed at the grantor's marginal tax rate; where the grantor has effectively divested himself of control and enjoyment, the income should be taxed to the beneficial owners of the trust. There is no persuasive justification for taxing a trust under its own graduated rate structure. The lowest marginal tax rate is designed to protect low-income individuals from paying an undue percentage of their income as tax. Although this rationale applies to individual trust beneficiaries, it does not apply to trusts as separate entities.

Although the throwback rules are designed to prevent income splitting between trusts and beneficiaries in order to take advantage of trusts' separate rate structure, these rules often do not recapture the tax savings from the accumulation of income inside the trust. The throwback formula, for example, often does not properly reflect whether the beneficiary's tax rate declined between the time of accumulation and distribution. In addition, the throwback rules do not take into account the benefit of the deferral of tax during the period between the income accumulation and the taxation of an accumulation distribution. Finally, the throwback rules are wholly inapplicable to income accumulated while the beneficiary is under 21 years of age as well as to retained capital gain income.

Present law also permits a grantor to shift income to family members through creation of a trust, even when the grantor retains significant control over or a beneficial interest in the trust's assets. For example, trust income will not be taxed to the grantor even though the trust's assets will revert to the grantor as soon as ten years after the trust's creation. Similarly, trust income will not be taxed to the grantor even though the grantor appoints himself or herself as trustee with certain discretionary powers to accumulate income or distribute trust assets. Significantly broader discretion over trust income and distributions may be vested in an independent trustee, who, though not formally subject to the grantor's control, may be expected to exercise his or her discretion in a manner that minimizes the aggregate tax burden of the trust's grantor and beneficiaries.

Efficiency and Simplification

The significant income-splitting advantages that may be gained by placing income-producing assets in trust have resulted in greater utilization of the trust device than would be justified by non-tax economic considerations. Moreover, even where there are non-tax reasons for a trust's creation, tax considerations heavily influence the trustee's determination of whether to accumulate or distribute trust income. No discernable social policy is served by this tax incentive for the creation of trusts and the accumulation of income within them. Thus, current tax policy has not only sacrificed tax revenue with respect to trust income, it also has encouraged artificial and inefficient arrangements for the ownership and management of property.

The tax advantages that current law provides to trusts also have spawned a complex array of anti-abuse provisions. The grantor trust rules and the throwback rules are highly complex and often arbitrary in their application. Rules that attribute capital gain of certain non-grantor trusts to the grantor are also complex in operation and can have unforeseen consequences to trust grantors. In addition, the fact that the tax benefits of the trust form can be increased through the creation of multiple trusts has resulted in the creation of numerous trusts with essentially similar dispositive provisions. This "multiple trust" problem has necessitated a statutory response that would be unnecessary if the tax benefits of creating trusts could be minimized.

Proposal

Taxation of Trusts During Lifetime of Grantor

1. Overview

During the lifetime of the grantor, all trusts created by the grantor would be divided into two categories: trusts that are treated as owned by the grantor for Federal income tax purposes, because the grantor has retained a present interest in or control over the trust property; and trusts that are not treated as owned by the grantor, because the grantor does not have any present interest in or control over the property. As under current law, the income of a trust classified as a grantor-owned trust generally would be taxed directly to the grantor to the extent that the grantor is treated as the owner. A non-grantor-owned trust generally would be respected as a separate taxable entity. During the grantor's lifetime, however, income would be taxed to the trust at the grantor's marginal tax rate, unless the trust instrument requires the distribution of income to specified beneficiaries.

2. Grantor-owned trusts

The grantor would be treated as the owner of a trust to the extent that (i) payments of property or income are required to be made currently to the grantor or the grantor's spouse; (ii) payments of property or income may be made currently to the grantor or the grantor's spouse under a discretionary power held in whole or in part by either one of them; (iii) the grantor or the grantor's spouse has any power to amend or to revoke the trust and cause distributions of property to be made to either one of them; (iv) the grantor or the grantor's spouse has any power to cause the trustee to lend trust income or corpus to either of them; or (v) the grantor or the grantor's spouse has borrowed trust income or corpus and has not completely repaid the loan or any interest thereon before the beginning of the taxable year. For purposes of these rules, the fact that a power held by the grantor or the grantor's spouse could be exercised only with the consent of another person or persons would be irrelevant, regardless of whether such person or persons would be characterized as "adverse parties" under present law.

The present law rules under which a person other than the grantor may be treated as owner of a trust would be retained and made consistent with these rules. A grantor or other person who is treated as the owner of any portion of a trust under these rules would be subject to tax on the income of such portion. Transactions between the trust and its owner would be disregarded for Federal income tax purposes where appropriate.

3. Non-grantor-owned trusts

(a) In general. A trust that is not treated as owned by the grantor or by any other person under the rules described above would be subject to tax as a separate entity. Unlike present law, however, non-grantor-owned trusts would be required to adopt the same taxable year as the grantor, thereby limiting the use of fiscal years by trusts to defer the taxation of trust income.

The trust would compute its taxable income in the same manner as an individual, but would not be entitled to a zero bracket amount or a personal exemption (or deduction in lieu of a personal exemption). The trust would be entitled to a deduction for charitable contributions, but only to the extent that the grantor would have received a deduction if the grantor were the owner of the entire trust. Thus, if the grantor's charitable contributions were less than two percent of his or her adjusted gross income, the trust would receive a charitable contribution deduction only to the extent that its contributions exceed the sum of the (i) grantor's unused charitable deduction floor and (ii) two percent of the trust's adjusted gross income. See Ch. 3.18. In order to be deductible, a charitable contribution would have to be made within 65 days of the close of the trust's taxable year.

(b) Distribution deduction. The present rules regarding the deductibility of distributions made by a trust to non-charitable beneficiaries would be substantially changed. First, during the lifetime of the grantor, only mandatory distributions would be deductible by a trust. A distribution would qualify for this deduction only if a fixed or ascertainable amount of trust income or property is required to be distributed to a specific beneficiary or beneficiaries. As under present law, distributions required to be made would be deductible regardless of whether actually made by the trustee.

The amount of a mandatory distribution would be considered fixed or ascertainable if expressed in the governing instrument as a portion or percentage of trust income. The requirement that each beneficiary's share be fixed or ascertainable also would be satisfied by a requirement that distributions be made on a per capita or per stirpital basis that does not give any person the right to vary the beneficiaries' proportionate interests. Thus, distributions would not qualify as mandatory if the governing instrument requires the distribution of all income among a class of beneficiaries, but gives any person the right to vary the proportionate interests of the members of the class in trust income.

A distribution would be considered mandatory if required upon the happening of an event not within the control of the grantor, the grantor's spouse, or the trustee, such as the marriage of a beneficiary or the exercise by an adult beneficiary of an unrestricted power of withdrawal. The requirement that the governing instrument specify the beneficiary or beneficiaries of a mandatory distribution would be satisfied if a class of beneficiaries were specified and particular beneficiaries could be added or removed only upon the happening of certain events not within the control of the grantor, grantor's spouse, or trustee, such as the birth or adoption of a child, marriage, divorce, or attainment of a certain age.

Second, unlike present law, property required to be irrevocably set aside for a beneficiary would be treated as a mandatory distribution, provided the amount set aside is required to be distributed ultimately to the beneficiary or the beneficiary's estate, or is subject to a power exercisable by the beneficiary the possession of which will cause the property to be included in the beneficiary's estate for Federal estate tax purposes. Thus, the trustee could designate property as irrevocably set aside for a beneficiary and obtain a distribution deduction (provided that a distribution or set-aside is mandatory under the governing instrument) without making an actual distribution to the beneficiary.

If the tax imposed on a beneficiary by reason of a set-aside exceeds the amount actually distributed to the beneficiary in any year, the beneficiary could be permitted under the governing instrument to obtain a contribution from the trustee equal to the tax liability imposed by reason of the set-aside (less any amounts previously distributed to the beneficiary during the taxable year). Such contribution would be paid out of the amount set aside, and therefore would not carry out additional DNI. This structure, unlike present law, would permit a fiduciary to obtain the benefit of a beneficiary's lower tax bracket through an irrevocable set-aside. Accordingly, tax motivations would not override non-tax factors which might indicate that an actual distribution is undesirable.

Third, whether mandatory or not, distributions to non-charitable beneficiaries would not be deductible during the lifetime of the grantor under the following circumstances indicating incomplete relinquishment of interest in or dominion and control over the trust:

(i) If any person has the discretionary power to make distributions of corpus or income to the grantor or the grantor's spouse;

(ii) If any portion of the trust may revert to the grantor or the grantor's spouse, unless the reversion cannot occur prior to the death of the income beneficiary of such portion and such beneficiary is younger than the grantor, or prior to the expiration of a term of years that is greater than the life expectancy of the grantor at the creation or the funding of the trust;

(iii) If any person has the power exercisable in a non-fiduciary capacity to control trust investments, to deal with the trust for less than full and adequate consideration, or to exercise any general administrative powers in a non-fiduciary capacity without the consent of a fiduciary;

(iv) If and to the extent that an otherwise deductible mandatory distribution satisfies a legal obligation of the grantor or grantor's spouse, including a legal obligation of support or maintenance; or

(v) If trust income or corpus can be used to carry premiums on life insurance policies on the life of the grantor or the grantor's spouse with respect to which the grantor or the grantor's spouse possesses any incident of ownership.

(c) Computation of tax liability. Once the taxable income of an inter vivos trust has been computed under the rules described above, the trust's tax liability would be determined. This liability would be the excess of (i) the tax liability that would have been imposed on the grantor had the trust's taxable income been added to the greater of zero or the grantor's taxable income and reported on the grantor's return, over (ii) the tax liability that is actually imposed on the grantor. Thus, the trust's tax liability generally would equal the incremental amount of tax that the grantor would have paid had the trust been classified as a grantor trust, with two exceptions. First, to avoid the difficulty associated with any recomputation of a grantor's net operating loss carryover and other complexities, if the grantor has incurred a loss in the taxable year or in a prior taxable year, such loss would be disregarded and the grantor would be deemed to have a taxable income of zero for purposes of computing the trust's tax liability. Second, the addition of the trust's taxable income to the taxable income of the grantor would not affect the computation of the grantor's taxable income. For example, trust income would not be attributed to the grantor for purposes of determining the grantor's floor on various deductions. See Ch. 3.18 and Ch. 4.03.

If the grantor has created more than one non-grantor trust, then each such trust would be liable for a proportionate share of the tax that would result from adding their aggregate taxable income to the greater of zero or the grantor's taxable income. If one or more trusts do not cooperate with the grantor and other trusts in determining their tax liability under these rules, the trusts failing to cooperate would be subject to the highest marginal rate applicable to individuals and would be ineligible for the charitable contribution deduction. Similarly, if the grantor does not provide a trustee with information sufficient to enable the trustee to compute the trust's tax liability under these rules, the trustee would be required to assume (for purposes of computing the trust's tax) that the grantor had taxable income placing him or her in the highest marginal rate and had an unused charitable deduction floor that exceeds the trust's charitable contributions.

(d) Taxation of beneficiaries. As under current law, distributions to beneficiaries that are deductible by a trust would be taxable to the beneficiaries, with the trust's DNI representing the maximum amount deductible by the trust and includible in the income of the beneficiaries. Capital gain deemed to be distributed would be included in the computation of the trust's DNI. Capital gain income would be deemed to be distributed if the trust instrument requires that it be distributed or if and to the extent that mandatory distributions and set-asides exceed DNI (as computed without regard to such gain). Each recipient of a required distribution or set-aside would take into account his or her proportionate share of DNI. Thus, the tier rules of present law would be eliminated. Each item entering the computation of DNI, including capital gains that are deemed to be distributed and hence are included in DNI, would be allocated among the beneficiaries and the trust, based on the proportionate amounts distributed to or set aside for each beneficiary.

(e) Multiple grantors. For purposes of determining whether the grantor is the owner of any portion of a trust, and for purposes of determining whether a mandatory distribution is deductible, if there is more than one grantor, a trust would be treated as consisting of separate trusts with respect to each grantor. If a husband and wife are both grantors with respect to a trust, however, they would be entitled to elect one of them to be treated as the grantor with respect to the entire trust. Once made, such an election would be irrevocable and would apply to all subsequent transfers made during the course of the marriage by either spouse.

Taxation of Trusts After Death of Grantor

For all taxable years beginning after the death of an individual, all inter vivos and testamentary trusts established by such individual would compute their taxable income as in the case of an individual, but with no zero bracket amount, no personal exemption (or deduction in lieu of a personal exemption), and with a distribution deduction for all distributions or set-asides required to be made and for all distributions and set-asides, whether mandatory or discretionary, actually made to or for non-charitable beneficiaries. As under present law, distributions made within 65 days of the close of the taxable year would be treated as made on the last day of the taxable year. A similar rule would apply to set-asides. Charitable contributions would be fully deductible to the extent that they exceed two percent of the trust's adjusted gross income. All trusts would compute DNI in the same manner as non-grantor trusts. Any taxable income of the trust would be subject to tax at the highest individual marginal rate.

For the taxable year in which the grantor's death occurs, a grantor-owned trust would close a short taxable year ending with the date of the grantor's death, and its income for such period would be taxed to the grantor as under present law. For the remainder of the taxable year, the trust would compute its taxable income with a distribution deduction computed under the post-death rules. Rather than being subject to tax at the highest marginal rate, however, the trust would compute its tax liability for this short taxable period by adding its taxable income to the taxable income of the grantor for the grantor's final taxable year.

For the period ending with the death of the grantor, a non-grantor-owned inter vivos trust would compute taxable income in the same manner as before the death of the grantor. Accordingly, such a trust would be entitled to a deduction for qualifying distributions to charity and for all mandatory distributions or set-asides with respect to non-charitable beneficiaries. The trust's taxable year would not terminate with the death of the grantor, but the trust would be entitled to a distribution deduction under the post-death rules for all distributions or set-asides made after the grantor's death. As with taxable years ending before the grantor's death, the trust would compute its tax liability for the grantor's final year by reference to the taxable income of the grantor.

Testamentary trusts would compute their income using the same taxable year as the decedent and the decedent's estate. A testamentary trust created before the end of the taxable year of the decedent's death would compute its tax liability for its first (short) taxable year along with all other trusts created by the decedent, by reference to the decedent's taxable income for that year.

Effective Date

The proposal would apply generally to irrevocable trusts created after the date that legislation containing the proposal is introduced and to trusts that are revocable on the date that the legislation is introduced, for taxable years beginning on or after January 1, 1986. A trust that is irrevocable on the date that the legislation is introduced would nevertheless be treated as created after the date that the legislation is introduced if any amount is transferred to such trust after such date. Similarly, a trust that is revocable on the date that the legislation is introduced and that becomes irrevocable after such date would be treated as a new trust for purposes of these rules. A trust that is created after the date that legislation is introduced, but prior to January 1, 1986, would be required to adopt the taxable year of the grantor.

For trusts that are irrevocable on the date that the legislation is introduced, the proposal would apply according to the following rules. Trusts that are grantor trusts under present law would be subject to the new rules beginning with the first taxable year of the grantor that begins on or after January 1, 1986. If a trust that is classified as a grantor trust under present law is classified as a non-grantor trust under the new rules, however, it would be entitled to elect to be treated as if the grantor were the owner for Federal income tax purposes (such election to be made jointly by the grantor and the trustee).

With respect to trusts that are irrevocable on the date that the legislation is introduced and are not classified as grantor trusts under present law, the proposal would apply to taxable years beginning on or after January 1, 1986, with the following exceptions. First, if such a trust has already validly elected a fiscal year other than the grantor's taxable year on the date the legislation is introduced, the trust would be entitled to retain that year as its taxable year. In a case where the grantor and the trust have different taxable years, the trust would compute its tax liability by reference to the grantor's income for the grantor's taxable year ending within the taxable year of the trust. Second, such trusts would be entitled to a distribution deduction for all distributions and set-asides, whether discretionary or mandatory, made during the grantor's lifetime. Finally, such trusts would be entitled to elect to continue the tier system of present law for allocating DNI among trust beneficiaries.

With respect to income accumulated prior to the January 1, 1986, the throwback rules generally would be repealed. However, distributions out of previously accumulated income would be subject to tax in the hands of the beneficiary when distributed. Because the beneficiary's rate of tax may be significantly lower than under current law, the beneficiary would not be entitled to any credit for the taxes previously paid by the trust. The trust would be able to avoid application of this transitional throwback rule by a distribution or set-aside on the last day of the taxable year beginning prior to January 1, 1986, or by paying a tax at the trust level on UNI subject to the throwback rules based on the highest individual rate applicable under present law (with a credit for taxes previously paid by the trust).

Analysis

Because all trust income would be taxed to the grantor, taxed to trust beneficiaries, taxed to the trust at the grantor's marginal rate (during the grantor's lifetime), or taxed to the trust at the highest individual rate (after the grantor's death), the proposal would eliminate the use of trusts as an income-splitting device. In this respect, the proposal would reinforce the integrity of the progressive rate structure and thus enhance the fairness of the tax system.

The proposal would, in general, permit the use of non-grantor trusts to shift income among family members only if distributions or set-asides are mandatory and only if the grantor has effectively relinquished all rights in the trust property (other than the exercise of certain powers as trustee). In addition, present law would be liberalized in that amounts irrevocably set aside for a beneficiary would be treated as actually distributed. At the same time, wholly discretionary distributions would be ineffective to shift income to trust beneficiaries regardless of the identity of the trustee.

The proposal also would result in substantial simplification of the rules for taxation of trust income. The throwback rules, the tier system, and the special rule taxing some trust capital gain to the grantor would be repealed. In addition, the present grantor trust rules would be replaced by rules causing trusts to be taxed as grantor trusts or denying a distribution deduction in fairly limited circumstances. Requiring virtually all new trusts to use a calendar year would eliminate the artificial tax advantage often created by the selection of fiscal years. The simplicity created by these rules would more than offset whatever complexity is created by taxing inter vivos trusts at the grantor's marginal rate in certain circumstances.

The removal of the artificial tax advantages of trusts would cause decisions regarding the creation of trusts to be based on non-tax considerations. For example, because the income of a ten-year "Clifford" trust would be taxed at the grantor's marginal rate with no distribution deduction, such trusts would be created only where warranted by non-tax considerations. At the same time, however, the proposal would not impose a tax penalty on the use of a trust to hold and to manage a family's assets. At the worst, during the grantor's lifetime, trust income would be taxed as if the grantor had not established the trust. Although accumulated income would be taxed at the highest individual rate following the grantor's death, the deduction for set-asides as well as actual distributions would give the trustee ample flexibility to minimize the aggregate tax burden on trust income without making distributions.

REVISE INCOME TAXATION OF ESTATES

General Explanation

Chapter 3.26

Current Law

Under present law, a decedent's estate is recognized as a separate taxable entity for Federal income tax purposes. The separate existence of the estate begins with the death of the decedent, and the estate computes its income without regard to the decedent's taxable income for the period prior to the decedent's death. Because the estate's separate existence begins with the decedent's death, the estate is entitled to adopt its own taxable year without regard to the taxable year of the decedent or the taxable year of any beneficiary of the estate. Furthermore, any trust created by the decedent's will is entitled to select its own taxable year without regard to the year selected by the estate.

An estate generally computes its income in the same manner as an individual, with a $600 deduction allowed in lieu of the personal exemption. The amount of tax on an estate's income generally is determined in the same manner as a trust -- with a deduction allowed for distributions not in excess of distributable net income (DNI) -- except that the throwback rules applicable to trusts do not apply to estates. Thus, an estate can accumulate taxable income using its separate graduated rate structure and distribute the income in a later year free of any additional tax liability.

Under present law, the decedent's final return includes all items properly includible by the decedent in income for the period ending with the date of his death. All income received or accrued after the date of death is taxed to the estate rather than the decedent. The decedent's surviving spouse may elect, however, to file a joint Federal income tax return for the taxable year in which the decedent's death occurs.

Reasons for Change

Present law provides an incentive for the fiduciary of an estate to continue the period of administration for as long as possible in order to take advantage of the estate's separate graduated rate structure. Although current regulations provide for termination of an estate as a separate entity if the period of administration is unreasonably prolonged, the regulations are generally ineffective and seldom applied. Even where the period of administration is not unnecessarily extended, the inapplicability of the throwback rules to estates creates the likelihood that estate income will be subject to tax at a lower rate than the marginal tax bracket of the ultimate recipient.

The availability to an estate of a taxable year other than the calendar year creates tax avoidance opportunities. By appropriately timing distributions to beneficiaries of the estate, tax on income generated in the estate may be deferred for a full year. This deferral potential is exacerbated through the use of different fiscal years by testamentary trusts.

Estates can also use "trapping distributions" to allocate estate income among the maximum number of taxpayers and thereby minimize the aggregate tax burden imposed on estate income. The current rules for taxation of income during the taxable year in which the decedent dies create additional distortions. There is no necessary correlation between the timing of items of income and deduction and the date of death. Thus, for example, deductible expenses incurred prior to the date of death are not matched against income received after the date of death. This can result in the wasting of deductions on the decedent's final return or the stacking of income in the decedent's estate.

Proposal

The rules governing the taxation of estates would be changed so that the decedent's final taxable year would continue through the end of the taxable year in which his death occurs. Distributions by the decedent's personal representative to beneficiaries of the decedent's estate would not give rise to a distribution deduction against the decedent's income.

The first taxable year of the estate as a separate entity would be the first taxable year beginning after the decedent's death. The estate would be subject to tax at a separate rate schedule, with no zero bracket amount, no personal exemption (or deduction in lieu of a personal exemption), and no deduction for distributions to beneficiaries.

At its election, however, an estate could compute its taxable income in the same manner as any trust following the death of the grantor. The election, once made, would apply to all subsequent years. Thus, the estate would be entitled to a deduction for distributions or set-asides that carry out DNI, and such distributions or set-asides would be taxable to the beneficiaries. Any amount of an estate's taxable income not distributed or irrevocably set aside currently would be subject to tax at the highest individual marginal rate. For this purpose, set-asides and distributions made within 65 days of the close of the taxable year would be treated as made on the last day of the taxable year. As under present law, distributions or set-asides that are made in satisfaction of a bequest or gift of specific property or a specific sum of money would not carry out DNI, although an estate (or trust) would be entitled to elect to have specific gifts or bequests carry out DNI (with the consent of the distributee). Appropriate rules would be provided to limit the ability of estates to obtain unintended tax benefits by prolonging their administration.

Effective Date

The proposal would apply to estates of decedents dying on or after January 1, 1986.

Analysis

By placing estates on the same taxable year as the decedent, the proposal would eliminate the selection of a taxable year for an estate that defers the taxation of the estate's income. Moreover, the denial of a distribution deduction would prevent the splitting of income between the estate and its beneficiaries, while permitting estate income to be taxed under a separate rate schedule. In cases in which the absence of a distribution deduction was undesirable, however, the executor could elect to have the estate taxed as if it were a post-death trust.

CHAPTER 4

SIMPLIFICATION

Simplification is advanced by a number of the Treasury Department proposals discussed in other chapters. This chapter is devoted to proposals particularly aimed at simplifying the tax system for individuals. The greatest simplification for individuals could come from a fundamental change in the procedures for collecting tax liabilities -- the elimination of the income tax return for many taxpayers. The Internal Revenue Service will consider implementing a return-free system for taxpayers who today file uncomplicated returns.

The proposals also would repeal the minimum tax for individuals, the political contribution credit and the presidential campaign check-off, and the adoption expense deduction. A floor would be imposed on employee business expenses and miscellaneous itemized deductions.

STUDY RETURN-FREE SYSTEM

General Explanation

Chapter 4.01

Current Law

Individuals whose income exceeds specified levels are required to file income tax returns each year.

Reasons for Change

The requirement to file income tax returns imposes a paperwork burden on taxpayers. This burden should be reduced to the extent consistent with sound tax administration.

Proposal

The Internal Revenue Service is considering the implementation of a return-free tax system. Individual taxpayers who meet requirements to be specified by the Internal Revenue Service would not be required to file income tax returns. Under a return-free system, the Internal Revenue Service would, at the election of each eligible taxpayer, compute the taxpayer's liability, based on withholding and information reports provided to the Internal Revenue Service currently. The taxpayer would be sent a report, which would set forth the taxpayer's tax liability, and the taxpayer would be free to challenge the Internal Revenue Service's calculation of tax.

Analysis

Institution of the return-free system, together with the increases in zero bracket amounts and the personal exemptions, would substantially reduce the number of returns that taxpayers need to file with the Internal Revenue Service each year. This, in turn, would eliminate burdensome recordkeeping required of taxpayers and costs incurred by them in preparing returns. The return-free system would initially be limited to single wage earners with uncomplicated financial transactions, roughly the 15 million taxpayers now filing the simplified Form 1040EZ. After a pilot program, the system could be extended to other individual taxpayers, and by 1990, roughly 66 percent of all taxpayers could be covered by the return-free system. It is estimated that at this level of participation the return-free system would save taxpayers annually approximately 97 million hours and $1.9 billion in fees paid to professional tax preparers.

REPEAL ALTERNATIVE MINIMUM TAX

General Explanation

Chapter 4.02

Current Law

Taxpayers whose taxable incomes are substantially reduced by specified "items of tax preference" are subject to "minimum taxes" which may increase their overall tax liabilities. Noncorporate taxpayers with substantial tax preferences are subject to the "alternative minimum tax."

Noncorporate taxpayers whose regular tax liabilities are substantially reduced by tax preferences are, in effect, subject to the alternative minimum tax (AMT) in lieu of the regular income tax. The AMT is equal to 20 percent of the excess of the taxpayer's "alternative minimum taxable income" (AMTI) over an exemption amount.*/ A taxpayer's AMTI is computed by (a) adding tax preferences back to adjusted gross income, (b) subtracting the "alternative tax itemized deductions," and (c) making adjustments for net operating loss carryovers and certain trust distributions included in income under the so-called "throwback rules." The alternative tax itemized deductions include (a) casualty losses, (b) charitable contributions, (c) a portion of deductible medical expenses, (d) certain interest expenses (including interest on debt incurred to acquire the taxpayer's principal residence), and (e) estate taxes attributable to income in respect of a decedent. The exemption amount for the AMT is (a) $40,000 for a joint return or a surviving spouse, (b) $30,000 for a single taxpayer, and (c) $20,000 for other noncorporate taxpayers.

Items of tax preference generally include:

(a) interest and dividends excluded from gross income;

(b) the excess of accelerated over straight-line depreciation for real property and leased personal property (other than recovery property);

(c) in the case of recovery property other than leased 18-year real property, the excess of ACRS deductions over depreciation

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*/ The statutory term "alternative minimum tax" actually refers to the excess of (1) 20% of AMTI less the exemption amount over (2) the regular income tax. This excess is imposed in addition to the regular tax. For convenience, however, the terms "alternative minimum tax" and "AMT," as used herein, will refer to the sum of the true alternative minimum tax and the regular income tax.

deductions that would have been allowed had the property been depreciated using under the straight-line method over prescribed (extended) recovery periods;

(d) the tax preference for capital gains;

(e) the excess of amortization deductions for pollution control facilities over depreciation deductions that would otherwise have been allowable in the absence of special amortization;

(f) in the case of mining exploration and development costs and circulation expenditures, the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs or expenditures been amortized over a ten-year period;

(g) in the case of intangible drilling and development costs of oil, gas, and geothermal properties, the amount by which (i) the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period, exceeds (ii) the taxpayer's net income from oil, gas, and geothermal properties;

(h) the excess of depletion deductions over the basis of the depletable property; and

(i) in the case of stock transferred pursuant to the exercise of an incentive stock option, the excess of the fair market value over the option price.

Reasons For Change

The alternative and corporate minimum taxes were originally enacted as part of the Tax Reform Act of 1969 to ensure that "all taxpayers are required to pay significant amounts of tax on their economic income." The measures (originally a single minimum tax for all taxpayers) were considered necessary because, as concluded by Congress, "many individuals and corporations did not pay tax on a substantial part of their economic income as a result of the receipt of various kinds of tax-favored income or special deductions."

The judgment that a minimum tax is necessary reflects an ambivalence about the desirability and effectiveness of the tax preferences subject to the tax. For example, percentage depletion and accelerated methods of depreciation have traditionally been allowed in part to subsidize the cost of productive depreciable assets and mineral production activities. However, Congress disapproved the necessary consequence that taxpayers receiving the bulk of their income from nonpreferred activities were taxed at relatively higher rates than taxpayers engaged in activities, such as real estate or natural resource production, that benefitted from tax preferences.

The ambivalence in current law toward tax preferences reflects significant doubt about their fairness, efficiency, costs in lost revenue and consequent effect on marginal tax rates. In general, the Treasury Department proposals accept these doubts as well founded and seek to redesign the income tax base to approximate more closely economic income. If the proposals were fully implemented, the alternative minimum tax would be unnecessary.

To the extent that (1) existing tax preferences (which generally cause a taxpayer's taxable income to be less than economic income) are phased out over an extended period, or (2) taxpayers currently holding tax-favored assets are permitted to retain benefits not available for after-acquired assets, immediate repeal of the alternative minimum tax would be inappropriate.

Proposal

The alternative minimum tax would be repealed.

Effective Date

The repeal would be effective for taxable years beginning on or after January 1, 1990.

Analysis

Currently, between 100,000 and 200,000 individuals, generally with large incomes, are subject to the alternative minimum tax. Because of the AMT's complexity and its interactions with numerous deductions and tax computations, many more taxpayers -- perhaps several million -- must actually compute the AMT to determine if they are subject to it. In addition to its computational complexity and burdens, the presence or potential presence of the AMT obscures the tax consequences of certain activities. Because the impact of the AMT may not be determinable until after the close of the taxable year, taxpayers are likely to act in ways that are not economically efficient, and, hence, do not allocate resources efficiently and do not maximize economic output.

IMPOSE FLOOR ON EMPLOYEE BUSINESS EXPENSE AND OTHER MISCELLANEOUS DEDUCTIONS

General Explanation

Chapter 4.03

Current Law

Four categories of employee business expenses may be deducted by taxpayers regardless of whether they itemize deductions. These are:

- o expenses paid by the employee and reimbursed by the employer;
- o employee expenses of travel, meals, and lodging while away from home;
- o employee transportation expenses; and
- o business expenses of employees who are outside salesmen.

Various miscellaneous itemized deductions are allowed for taxpayers who itemize deductions. These miscellaneous itemized deductions comprise all itemized deductions other than medical expenses, charitable contributions, interest, taxes, and theft and casualty losses. They include:

- o employee business expenses other than those described above, including educational expenses, union and professional dues, safety equipment, small tools, supplies, uniforms, protective clothing, professional subscriptions, and employment agency fees;
- o gambling losses not in excess of gambling winnings;
- o expenses of producing certain income, including fees for investment services, safe deposit box rentals, trustee fees, and tax return preparation and tax advice fess.

Reasons for Change

Allowance of the various employee business expense deductions and the miscellaneous itemized deductions complicates recordkeeping for many taxpayers. Moreover, the small amounts that are typically involved present significant administrative and enforcement problems for the Internal Revenue Service. These deductions are also a source of numerous taxpayer errors concerning what amounts and what items are properly deductible.

Proposal

Employee business expenses (other than those reimbursed by the employer) and the miscellaneous itemized deductions would be consolidated into a single category, together with the deduction for State and local taxes (other than income taxes) which are currently required to be itemized but which are incurred in carrying on an income-producing activity. To the extent that these items, in the aggregate, exceed one percent of a taxpayer's adjusted gross income (AGI), they would be deductible by the taxpayer, whether or not he itemizes deductions. In lieu of a deduction, employer reimbursements would be excluded from the employee's income to the extent that the employee would have been entitled to a deduction without regard to the one percent floor.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Disallowance of a deduction for a normal level of employee business expenses and miscellaneous itemized deductions would simplify recordkeeping, reduce taxpayer errors and ease administrative burdens for the Internal Revenue Service while still providing fair treatment for taxpayers who incur an unusually high level of such expenses.

In 1982, one-half of all itemizers claimed miscellaneous deductions of less than one-half of one percent of their AGI. Fifty-eight percent claimed deductions of less than one percent of their AGI, and 93 percent claimed deductions of less than five percent of their AGI. Thus, introduction of a "floor" or "threshold" of one percent of AGI would substantially reduce the number of returns claiming this deduction. The proposed extension of the miscellaneous deduction to nonitemizers would partially offset the revenue gain from introduction of the floor.

The proposal would broaden the tax base and, thus, contribute to the reduction in marginal tax rates. Any increase in tax liability resulting from this proposal should be more than offset by the reduced marginal rates and the increase in the zero bracket amount and the personal exemption.

REPEAL POLITICAL CONTRIBUTION CREDIT

General Explanation

Chapter 4.04

Current Law

Individuals are allowed a nonrefundable tax credit for contributions to political candidates and political action committees. The credit equals one-half of the first $100 ($200 for joint returns) of an individual's contributions during the year.

Reasons For Change

The tax credit for political campaign contributions is not related to the proper measurement of income, but rather is intended to encourage individuals to contribute to the cost of the political process. The actual effect of the political contribution credit in producing additional political contributions is open to question. The credit produces no marginal incentive for taxpayers who without regard to the credit would make contributions of $100 or more. The credit also creates no incentive for low-income individuals who have no income tax liability.

The political contribution credit presents administrative and compliance problems for the Internal Revenue Service. The subject matter of the credit may involve the Internal Revenue Service in sensitive inquiries about political affiliation. Moreover, the small dollar amounts involved on each tax return make verification difficult and expensive relative to the amounts involved. There are some indications that increasing numbers of taxpayers may be claiming credits for which no contributions have been made.

Finally, the political contribution credit creates complexity for taxpayers. It adds a line to income tax forms, and, for honest taxpayers, entails an additional recordkeeping burden.

Proposal

The credit for political contributions would be repealed.

Effective Date

The repeal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

In 1982, the political contribution credit was claimed on about 5.2 million returns, or about 6.6 percent of all individual returns with some tax liability before deducting tax credits.

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As shown in Table 1, the number of users of the credit is skewed heavily toward higher-income taxpayers. Only 2.8 percent of all returns with income of $10,000 or less (and with some tax liability) used the credit whereas 38.4 percent of all returns with income of $100,000 or more claimed the credit. However, because the credit is limited to $50 ($100 on joint returns), tax benefits slighly favor those in lower-income brackets. In 1982, the Federal revenue loss from the credit was $270 million. The percentage distribution of those benefits is shown in the Table 1.

Table 1

Use of the Political Contributions Tax Credit - 1982

AGI Class	Percentage of Returns Claiming Credit 1/	Distribution of Tax Benefit from Credit (percentages)	Distribution of Tax Liability (percentages)
$ 0 to 9,999	2.8	8.2	2.5
10,000 to 19,999	4.5	17.1	12.5
20,000 to 29,999	6.5	20.9	18.8
30,000 to 49,999	10.0	29.4	30.8
50,000 to 99,999	20.8	16.6	18.2
100,000 and over	38.4	7.8	17.2
All Returns	6.6	100.0	100.0

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

1/ Percentage of all returns with some tax liability before tax credits.

Even if a large portion of the tax reduction attributable to the credit is not simply a windfall benefit to taxpayers who would have made a contribution anyway, the total subsidy from the credit represents only a relatively small portion of total political campaign expenditures in the United States.

Repeal of the credit would not cause a significant increase in tax liability for any group of taxpayers.

REPEAL PRESIDENTIAL CAMPAIGN CHECK-OFF

General Explanation

Chapter 4.05

Current Law

The Presidential election campaign check-off permits each individual who has income tax liability to elect to have one dollar of that liability used to finance Presidential election campaigns. By statute, the check-off information must be either on the first page of the income tax return or on the page that bears the taxpayer's signature.

Reasons For Change

The Presidential election campaign check-off is unrelated to the purposes of the income tax and is a source of complexity for taxpayers. The check-off does not directly affect individual tax liabilities, but simply allows taxpayers to direct that a small portion of their taxes be spent in a particular way. The use of the tax return system for this purpose is unique to the campaign check-off. For the many taxpayers who do not understand its purpose or effect, the check-off is a source of confusion. In addition, the check-off complicates tax forms, significantly in the case of the shorter forms, such as the 1040EZ.

Proposal

The Presidential election campaign check-off would be repealed.

Effective Date

The repeal would be effective for tax liability in taxable years beginning on or after January 1, 1986.

Analysis

Approximately one-fourth of all taxpayers (one-third of those taxpayers with some income tax liability) use this provision to earmark funds for Presidential campaigns. The percentage of taxpayers using the provision varies somewhat between election and nonelection years.

Since use of the campaign check-off does not increase any individual's income tax liability, taxpayers would not be adversely affected by repeal of this provision. Repeal of the check-off would eliminate public funds for Presidential campaigns unless direct appropriations were provided.

REPEAL ADOPTION EXPENSE DEDUCTION

General Explanation

Chapter 4.06

Current Law

Current law permits a deduction for "qualified adoption expenses" paid or incurred during the taxable year. In general, qualified adoption expenses include the reasonable and necessary adoption fees, court costs, attorney's fees, and other expenses directly related to the legal adoption of a "child with special needs" as defined in the Social Security Act.

The maximum amount of qualified adoption expenses that may be deducted with respect to a child is $1,500. Moreover, no expense may be deducted as a qualified adoption expense if a credit or deduction is otherwise allowable for such expense or if such expense is paid for by a grant from a Federal, State or local program.

Reasons for Change

The allowance of a deduction for certain adoption expenses is an inappropriate way of providing Federal support for those who adopt children with special needs. Federal programs supporting such children or the families who adopt them should be under the supervision and control of agencies familiar with their needs. Such agencies should also have budgetary responsibility for costs of programs serving these purposes. Providing Federal support through the tax system is inconsistent with each of these objectives.

Proposal

The deduction for qualified adoption expenses would be repealed and replaced by a direct expenditure program.

Effective Date

The proposal would generally be effective for taxable years beginning on or after January 1, 1987 and would generally apply to expenses paid or incured after such date. Taxpayers having incurred qualified adoption expenses with respect to a child prior to the date the proposal is introduced in legislation would be entitled to deduct qualified adoption expenses incurred after the effective date with respect to such child.

Analysis

It is anticipated that a direct expenditure program would be enacted to continue Federal support for families adopting children with special needs. The effective date of such program should be coordinated with the proposed repeal of the current deduction.

CHAPTER 5

OTHER MISCELLANEOUS REFORMS

This Chapter discusses proposals to reform the moving expense and income averaging provisions. The limits on moving expenses would be increased to reflect current costs. Income averaging would be modified in line with its original purposes, by denying it to persons who were full-time students during the base period.

INCREASE LIMITS ON MOVING EXPENSES

General Explanation

Chapter 5.01

Current Law

An employee or self-employed individual is allowed a deduction in computing adjusted gross income for certain moving expenses incurred in connection with the commencement of work at a new principal place of work. Direct costs of moving (costs of moving household goods and personal effects and traveling from the former residence to the new residence, including the cost of meals and lodging en route) are deductible regardless of amount, provided that they are reasonable. In addition, certain indirect costs of moving are deductible, subject to a dollar limitation. Deductible indirect costs include:

(1) temporary living expenses (for up to 30 days) at a new job location;

(2) expenses of round trip travel (including meals and lodging), after obtaining employment, from the former residence to the general location of the new principal place of work for the purpose of searching for a new residence; and

(3) certain expenses incident to a sale, purchase, or lease of a residence, such as real estate commissions and State transfer taxes.

The deduction for indirect costs is limited to $3,000, with the deduction for items (1) and (2) combined not to exceed $1,500 of the $3,000. A husband and wife who begin work at a new principal place of employment in the same general location are subject to a single $3,000 (and $1,500) limitation.

In order for moving expenses to be deductible, the taxpayer's new principal place of work must be at least 35 miles farther from his former residence than was his former principal place of work. For a taxpayer with no former principal place of work, the new principal place of work must be at least 35 miles from his former residence. In addition, the taxpayer must generally either (a) be a full-time employee for at least 39 weeks during the 12-month period immediately following arrival at the general location of the new principal place of work, or (b) perform services as an employee or self-employed individual (or both) on a full-time basis in such general location for at least 78 weeks during the 24-month period immediately following arrival at the general location (of which at least 39 weeks must be during the 12-month period immediately following arrival).

Similar rules apply to moving expenses incurred in connection with the commencement of work at a new principal place of work outside the United States. In these cases, the dollar limitation on indirect costs is $6,000, with a limit of $4,500 on items (1) and (2).

Reasons for Change

Moving expenses that are related to a change or relocation in employment are properly deductible as an expense of producing income. Available data indicates, however, that the fixed limits on indirect moving expenses are inadequate in relation to the actual costs of moving. A review of moving expense deductions in 1979 revealed that a typical taxpayer's indirect moving expenses were approaching $10,000. Inflation has since increased the level of such expenses.

Inadequate deduction limits for moving expenses increase the costs of business-related moves for either the employer or the employee. Costs for employers increase where moving expense reimbursements are increased to account for taxation of the reimbursement to the employee. The after-tax cost of moving also increases for employees who are not reimbursed and who cannot deduct all of their legitimate moving expenses. These extra costs adversely affect the mobility of the labor force and thus reduce the efficiency of the economy generally.

Proposal

The overall dollar limitation on the deduction for indirect moving expenses would be increased from $3,000 to $10,000. The dollar limitation applicable to temporary living expenses and round trip travel expenses (items (1) and (2) above) would be increased from $1,500 to $3,000.

For moves from the United States to a foreign country, the overall dollar limitation would be increased from $6,000 to $10,000, and the limitation applicable to items (1) and (2) would be increased from $4,500 to $6,000. Moves from one foreign country to another foreign country would be subject to the same limitations that apply to moves within the United States.

All dollar limitations would be subject to indexing for future inflation.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Although costs incurred for all indirect moving expenses have increased, the costs associated with the sale, purchase and rental of housing (item 3 above) have shown the most significant increases. These expenses generally are a stable percentage of the cost of housing, which has increased greatly. For this reason, the proposed increase in the dollar limitation that is applicable to such expenses is proportionately greater than the proposed increase for other indirect moving expenses.

The proposed dollar limitations are based on data on the average moving expenses incurred by employees of the Internal Revenue Service. The proposed dollar limitations generally would cover the indirect moving expenses (including real estate commissions, transfer taxes, and other transaction costs) incurred by taxpayers in connection with the transfer of an average-priced house in the United States. However, because the cost of housing varies throughout the country, the proposed limits may not cover all legitimate indirect moving expenses in some areas. In particular, the costs associated with transferring even an average-priced house is expected to exceed the limits in some high-cost areas. Larger increases in the dollar limitations, however, would cause a significant increase in the revenue loss and, more importantly, would permit taxpayers who do no not live in high-cost areas to deduct costs associated with an extremely high standard of living. Such costs are in the nature of personal expenses and should not be deductible.

The proposal to index the dollar limitations would minimize the need for periodic review of the statute.

RESTRICT INCOME AVERAGING FOR FULL-TIME STUDENTS

General Explanation

Chapter 5.02

Current Law

Because of the progressive tax rate structure, an individual whose income varies widely from year to year pays more tax over a period of years than an individual who earns comparable income evenly over the same period. The income averaging provisions mitigate this effect. Under these provisions, if an eligible individual's income for the taxable year exceeds 140 percent of his average income for the three preceding years ("base years"), the effective tax rate applicable to such excess income ("averageble income") generally will be the rate that would apply to one-fourth of the averageble income. The individual's tax liability will be an amount equal to the sum of (i) the tax on 140 percent of the three-year base period income, plus (ii) four times the extra tax from stacking one-fourth of the averageble income on top of 140 percent of base period income.

Two basic eligibility requirements restrict the availability of income averaging. First, the individual must have been a citizen or resident of the United States during the current year and each of the base years. Second, the individual (and the individual's spouse) generally must have provided at least 50 percent of his or her support during each of the three base years. This support test need not be satisfied if:

(1) the individual has attained the age of 25 and was not a full-time student during at least four years after attaining the age of 21;

(2) more than one-half of the individual's taxable income for the current year is attributable to work performed during two or more of the base years; or

(3) the individual files a joint return for the current year and not more than 25 percent of the aggregate adjusted gross income on the joint return is attributable to such individual.

In the case of an individual filing a joint return, the above requirements must be met by both the individual and the individual's spouse.

An individual who has been a full-time student during any or all of the base years is permitted to use income averaging, provided that he or she is otherwise eligible.

Reasons for Change

Income averaging is intended primarily to benefit taxpayers with widely fluctuating incomes. Under current law, however, taxpayers with sharp but sustained increases in income, typically young persons entering the job market for the first time, may qualify for income averaging and benefit substantially from it. The availability of income averaging to such persons is inconsistent with the principles of the progressive tax structure.

The availability of income averaging to individuals who were full-time students during the base period is also a source of complexity. Application of the support test to full-time students is difficult and a frequent source of contention between taxpayers and the Internal Revenue Service. The case-by-case determinations that are required represent an administrative burden and prevent any fair and consistent application of the eligibility rules.

Proposal

A taxpayer who was a full-time student in any base year would not be eligible for income averaging. This rule, however, would not apply where an individual files a joint return and 25 percent or less of the adjusted gross income reportable on the joint return is attributable to the individual. Thus, the benefits of income averaging would be available in situations where one spouse was a full-time student during one or more of the base years but had a relatively insubstantial amount of income in the current year.

In conformity with these changes, the exception to the support rule for taxpayers who are 25 years of age or older and were not full-time students during at least four of the years after they reached 21 years of age would be eliminated.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would help restrict income averaging to its intended beneficiaries -- taxpayers whose incomes fluctuate widely from year to year. By reducing the number of taxpayers using the complex income averaging provisions, the proposal would simplify the tax system. The proposed flattening of the tax rate schedule also should reduce the number of taxpayers who use income averaging.